



# Global Sovereign Update & Outlook

Is the Positive EM Sovereign Cycle Already Over?

James McCormack

August 2018

**Fitch**Ratings

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## Key Messages, Risks and What's Changed – August 2018

### Global Implications of US Policy

- Is Everything Getting Worse? Trade and Politics

### Sovereign Ratings & Global Fiscal Update

### Country/Regional Considerations

- US / UK / China / Brazil / Argentina / Emerging Markets

### Appendixes

- Sovereign Criteria Schematic
  - Qualitative Overlay by Region
-

# Global Macro and Sovereign Credit Summary – August 2018

## Key Assumptions and Messages

- Good global growth – we remain confident of growth above 3% for 2018-2019, led by investment and trade
- China experiencing a gradual and managed slowing – deleveraging focus will continue to be on financial sector, not corporates
- Commodity prices higher, helping EM adjustments
- US monetary tightening in stride so far – no EM-wide increase in funding costs

## Global Risks in 2018 and Beyond

- US trade policy – the risk of it being even more aggressive
- Higher interest rates – if inflation picks up, concerns may turn to Fed being “behind the curve”
- Stronger US dollar – the big one
- High debt levels – DM sovereigns and EM dollar debt
- Politics/geopolitics – populism not a passing fad, Brexit, heightened geopolitical risks (Korea, Middle East)

## Sovereign Foreign Currency Rating Changes

	2010-2015 Annual Average	2016	2017	2017 January-July	2018 January-July
Upgrades	13	12	13	-	7
Downgrades	16	24	20	10	4

Source: Fitch, as of 30 July 2018

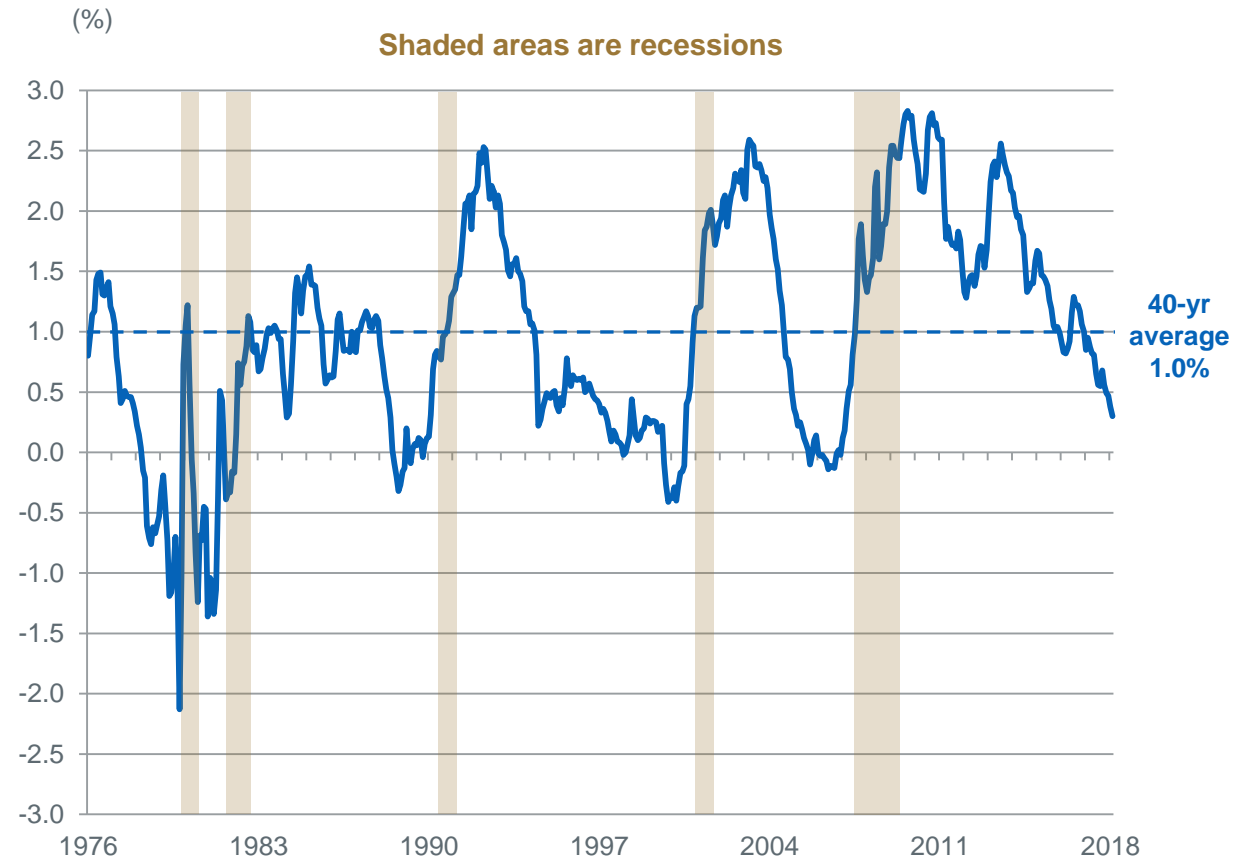
# Global Macro and Sovereign Credit Summary – August 2018

## What is Changing?

- **Global less synchronised, more divergent**
  - US and China growing faster than expected, elsewhere slower
- **Greater confidence in the Federal Reserve**
  - Powell message is clear; the economy is strong
- **Less confidence in the ECB**
  - We push back our rate increase to later in 2019
- **Trade war isn't a risk, it is a reality; what will China do?**
  - If US policies are implemented in full, with retaliation, 2019 global growth 2.8% instead of 3.2%
- **Heightened Brexit uncertainty**
  - Tail risks of “no deal” and “no Brexit” are growing
- **US yield curve is flatter**
  - But it is not inverted, and not implying recession

## Is This Really Telling Us Recession is Imminent?

### US Treasury Yields, 10-year minus 2-year

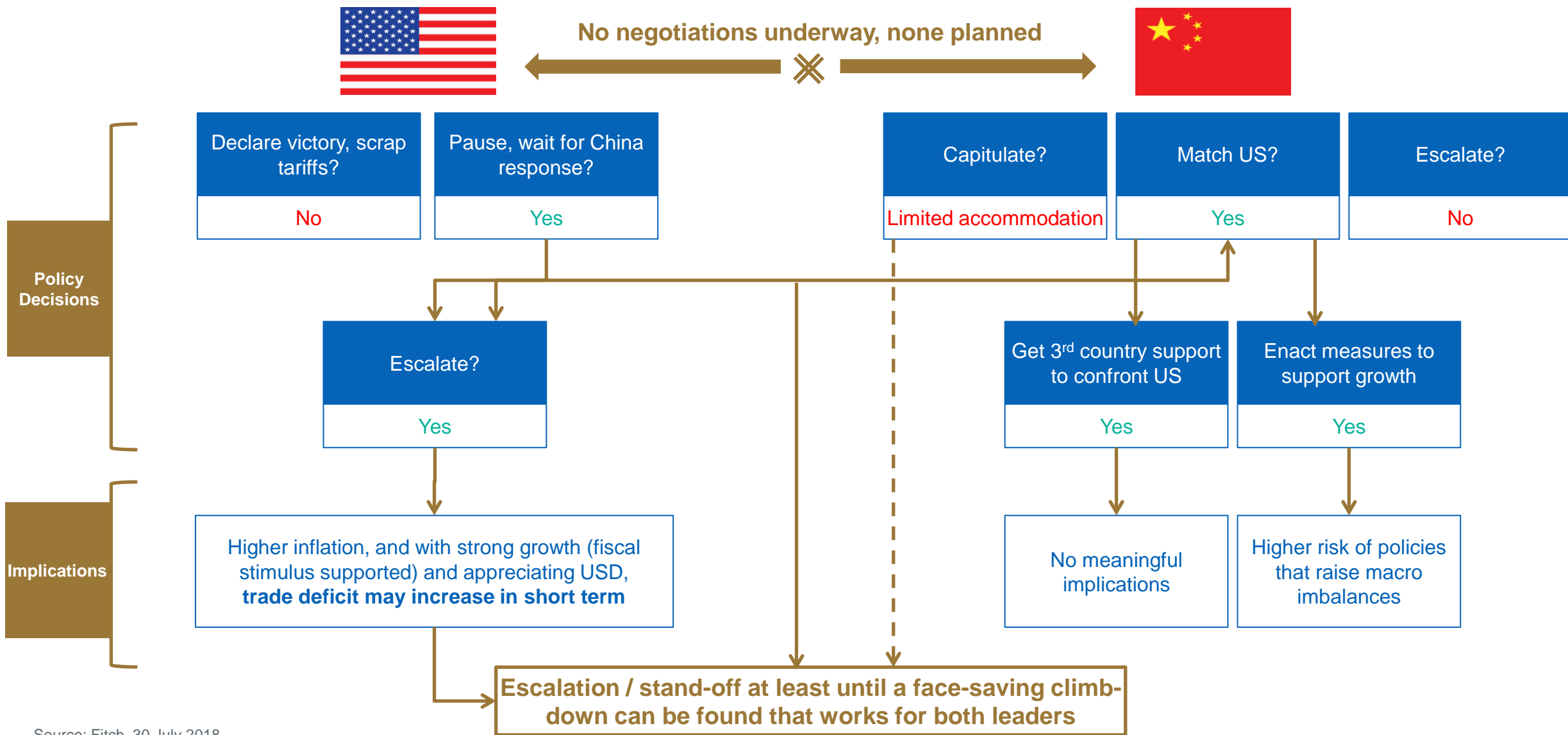


Sources: Datastream, Federal Reserve, Fitch, 30 July 2018



# Global Implications of US Policy

# Global Implications of US Policy – What's Next in the Trade War?

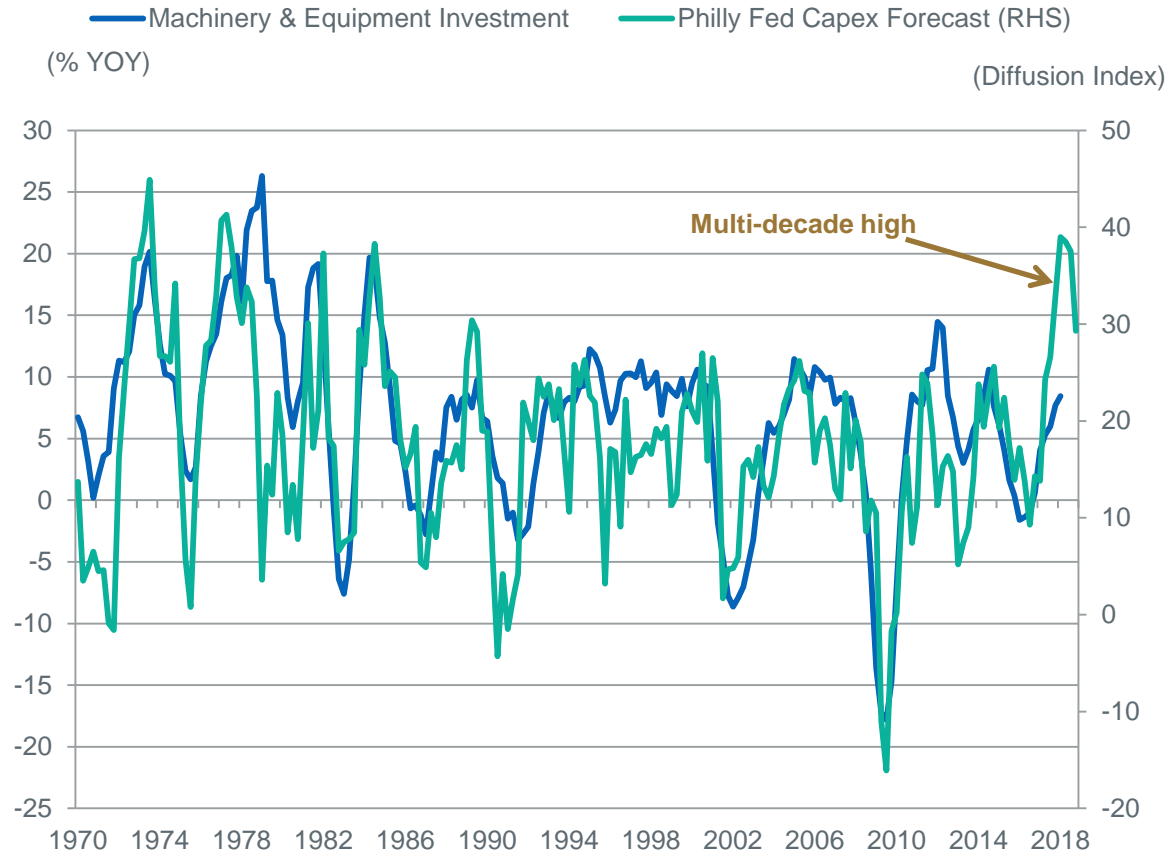


Source: Fitch, 30 July 2018

# Global Implications of US Policy – The Trade Deficit to Grow, Trade War Goes On

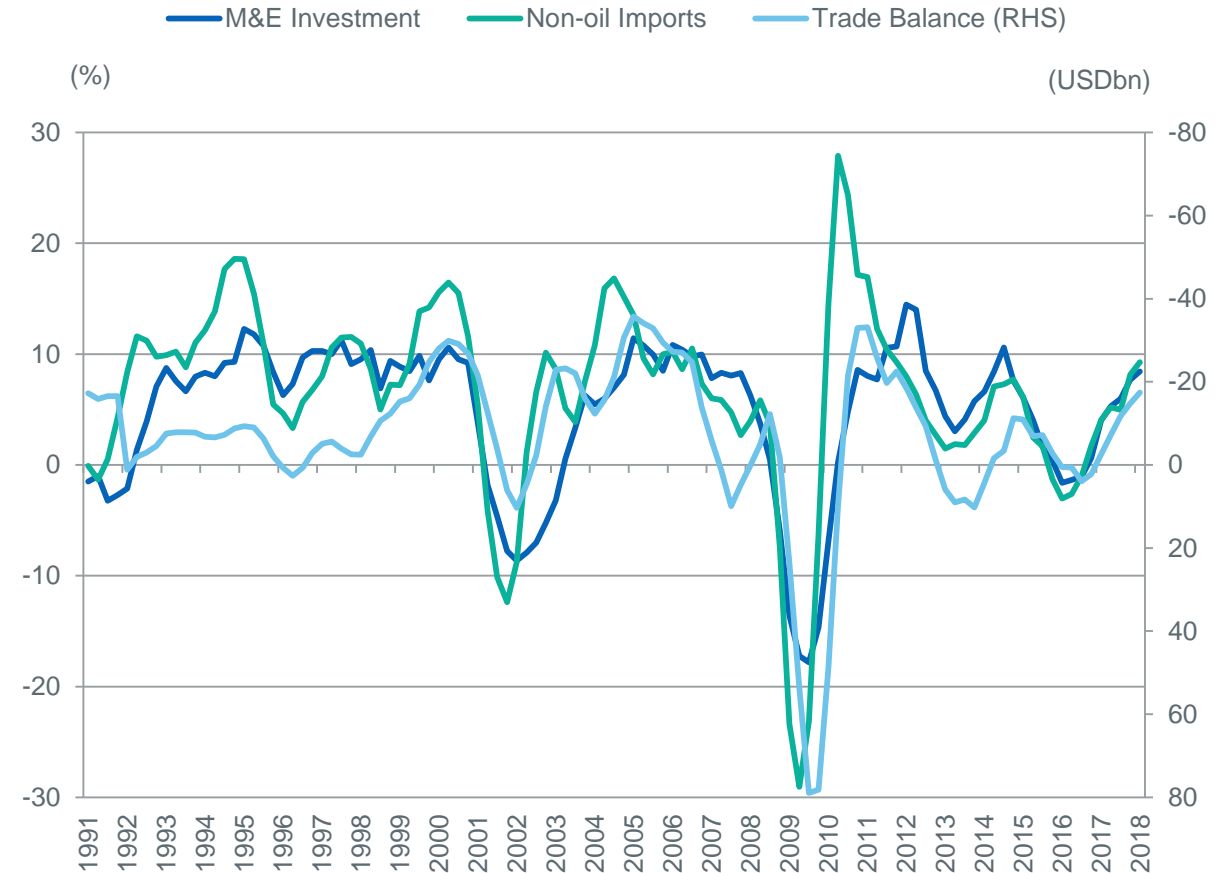
## US Investment Spending Intentions Very Strong

### Philly Fed Investment Survey and M&E Investment Growth



## Higher Investment Means More Imports, Larger Trade Deficit

### M&E Investment, Imports and Trade Deficit

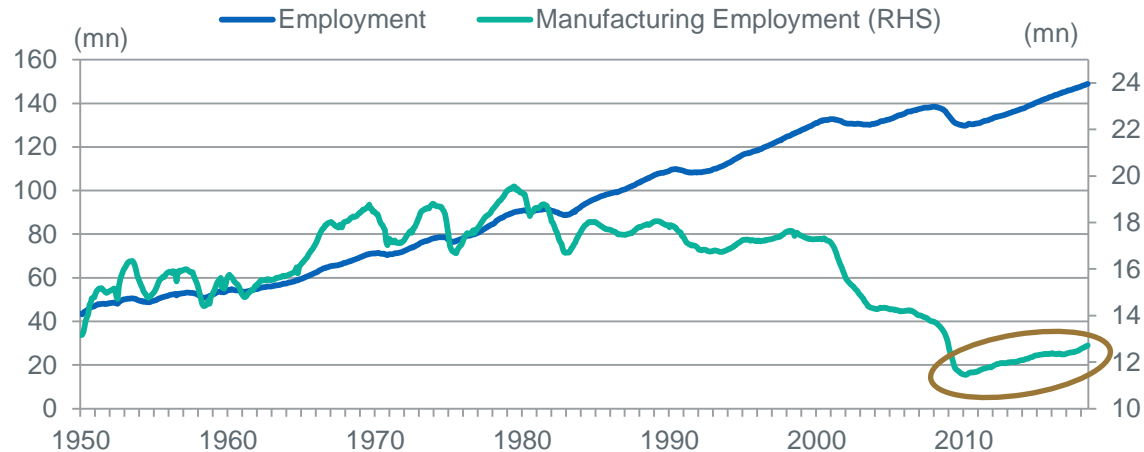


Source: Datastream, Fitch, 30 July 2018

# Global Implications of US Policy – No Immediate End in Sight

## How Does the Trade War End?

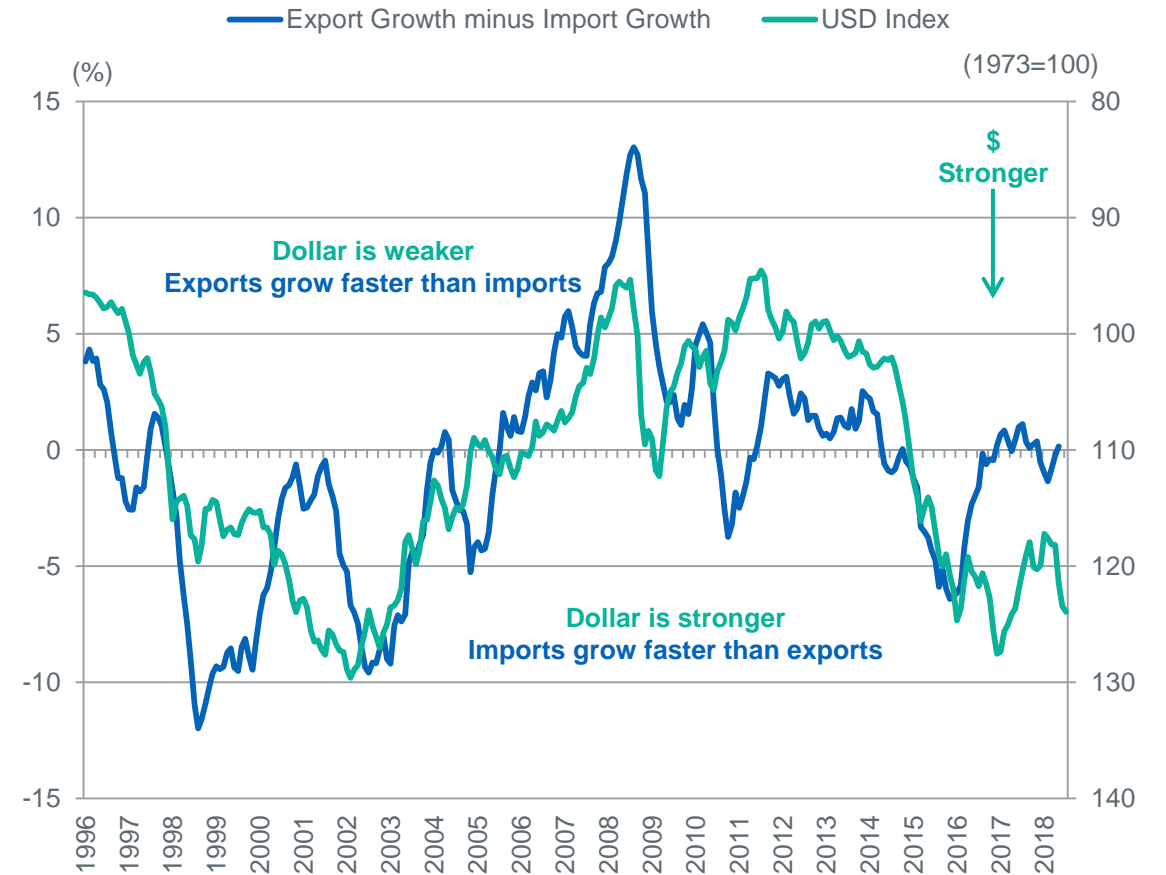
- **US macro conditions?**
  - Weaker dollar – but dollar getting stronger
  - Tighter fiscal policy – but policy getting looser
  - Slower growth – but growth accelerating
- **Dialogue?**
  - G20 meeting in Argentina – but no China-US meeting
- **Indefinite stand-off**
  - If US manufacturing employment grows, looks like success



Source: Datastream, Fitch, 30 July 2018

## US Trade Deficit Typically Improves Only When USD is Weak

### Export Growth, Import Growth and the USD





# Global Implications of US Policy – the Dollar to Strengthen

Fitch Policy Forecast	
Fiscal and monetary policies are not aligned, and trade policy adds a new dimension	
Fiscal Policy	<ul style="list-style-type: none"> <li>Decidedly expansionary from both tax cuts and spending increases</li> <li>Growing federal fiscal deficit</li> </ul>
Monetary Policy	<ul style="list-style-type: none"> <li>Four policy rate increases in 2018 followed by three in 2019</li> <li>More assured if inflation surprises higher</li> </ul>
Trade Policy	<ul style="list-style-type: none"> <li>Driven by bilateral trade deficit reduction</li> <li>An underlying protectionist bias</li> </ul>
<b>Net Directional Impact</b>	<ul style="list-style-type: none"> <li>Stronger growth and higher inflation mean more certainty around Fed, stronger USD</li> <li>Impact on trade balance is ambiguous</li> </ul>

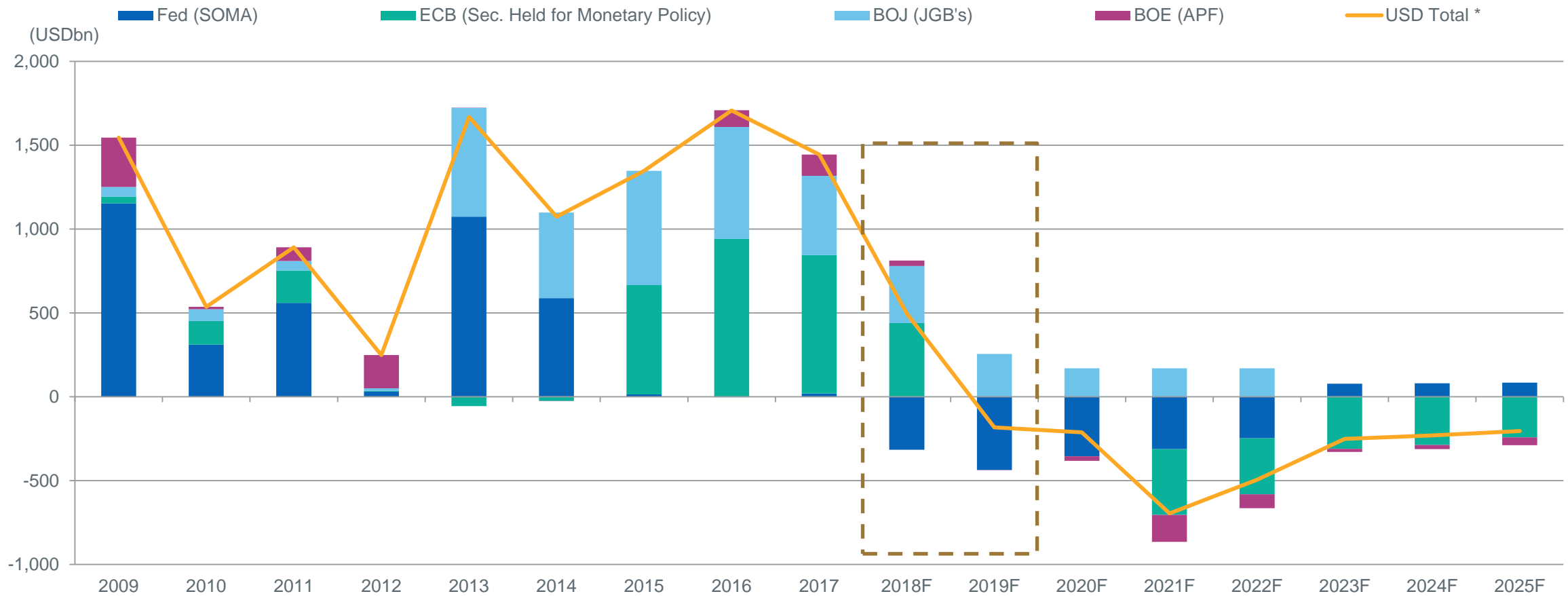
Directional Change 2018-2019			
Real Growth	Inflation	Trade Deficit	US Dollar
↑	↑	↑	↓
↓	↓	↓	↑
↓	↑	↓	↑
↑	↑	↑	↑

Source: Fitch, 30 July 2018

# Global Implications of Central Bank QE Policies

For the First Time in a Decade, Central Banks Will Be Net Sellers of Sovereign Debt in 2019 – and More in Years Ahead

## Central Bank QE Asset Purchases in US Dollars



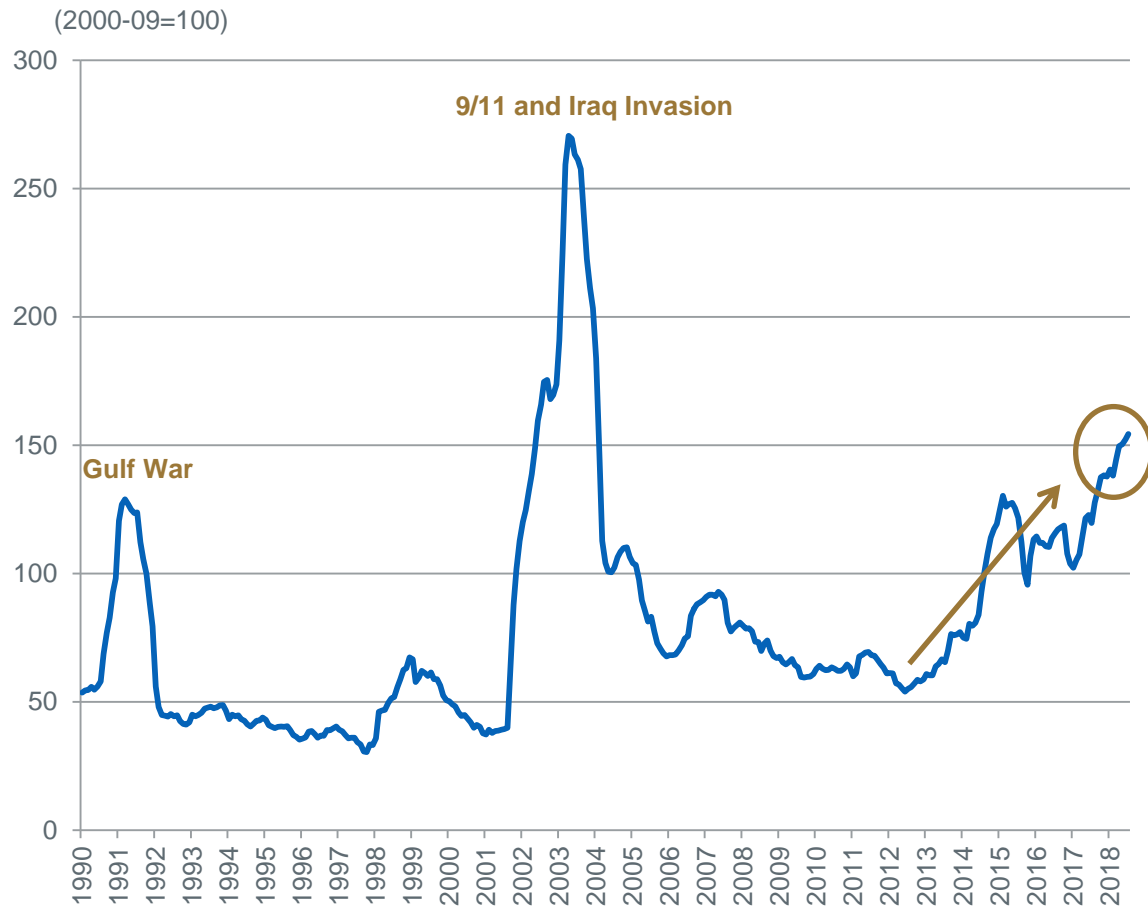
\*BOJ, BOE and ECB measured at annual average exchange rates

Source: Fitch, 30 July 2018

# Is Everything Getting Worse? Political Risks Rising

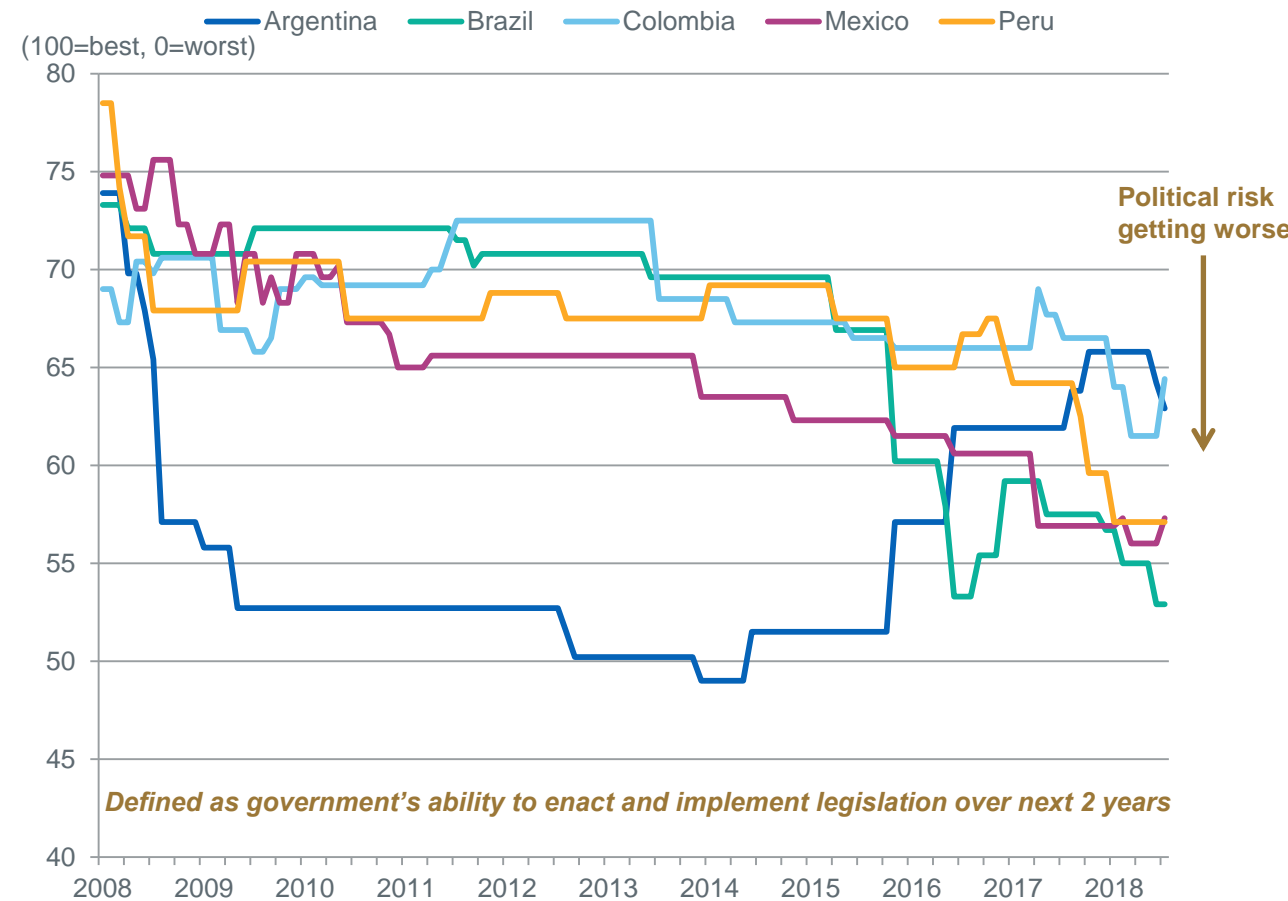
## Global Tension and the Risk of Conflict Are High and Rising

### Global Geopolitical Risk Index



## Uninspiring Political Risk Trends in Latin America

### Latin America Political Risk Indexes

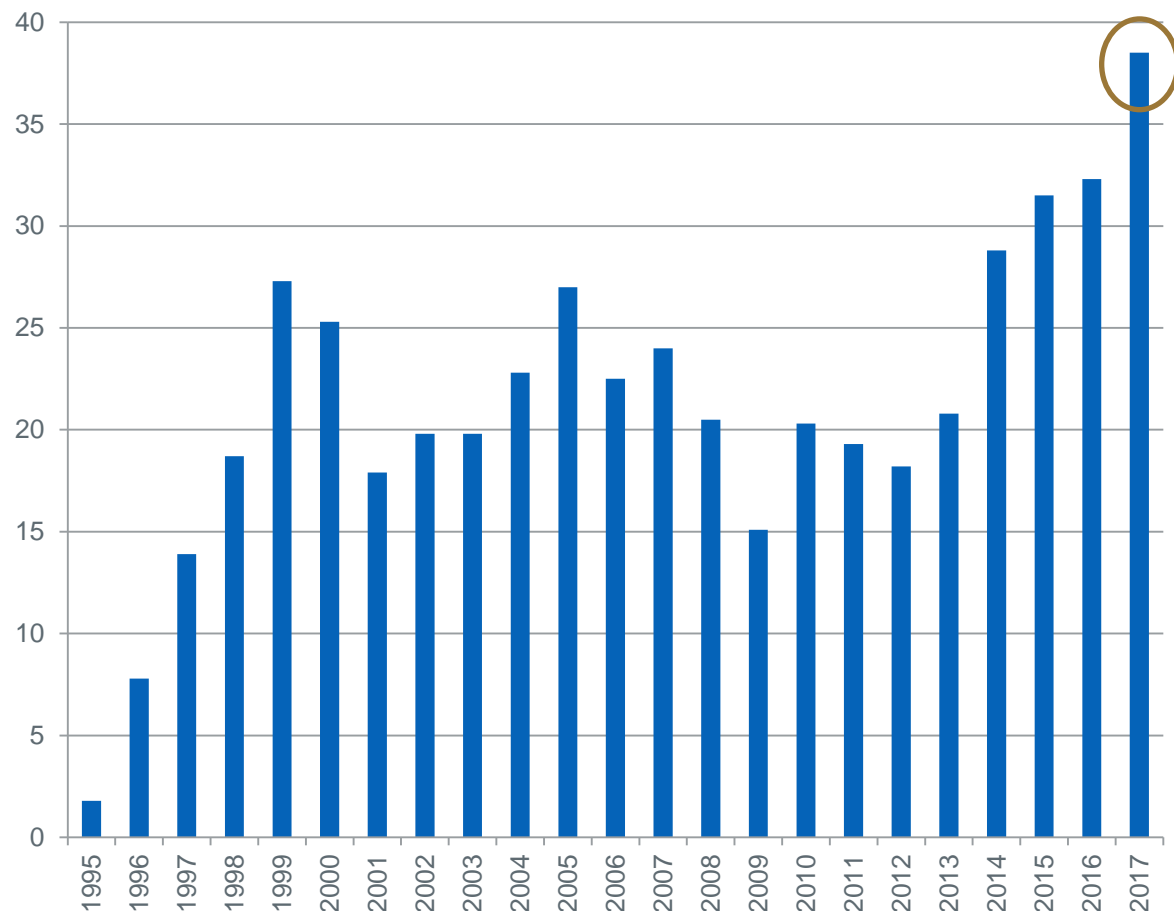


Source: Caldara, Dario and Matteo Iacoviello, "Measuring Geopolitical Risk", <https://www2.bc.edu/matteo-iacoviello/gpr.htm>, BMI, 30 July 2018

# Is Everything Getting Worse? Protectionist Tendencies on the Rise

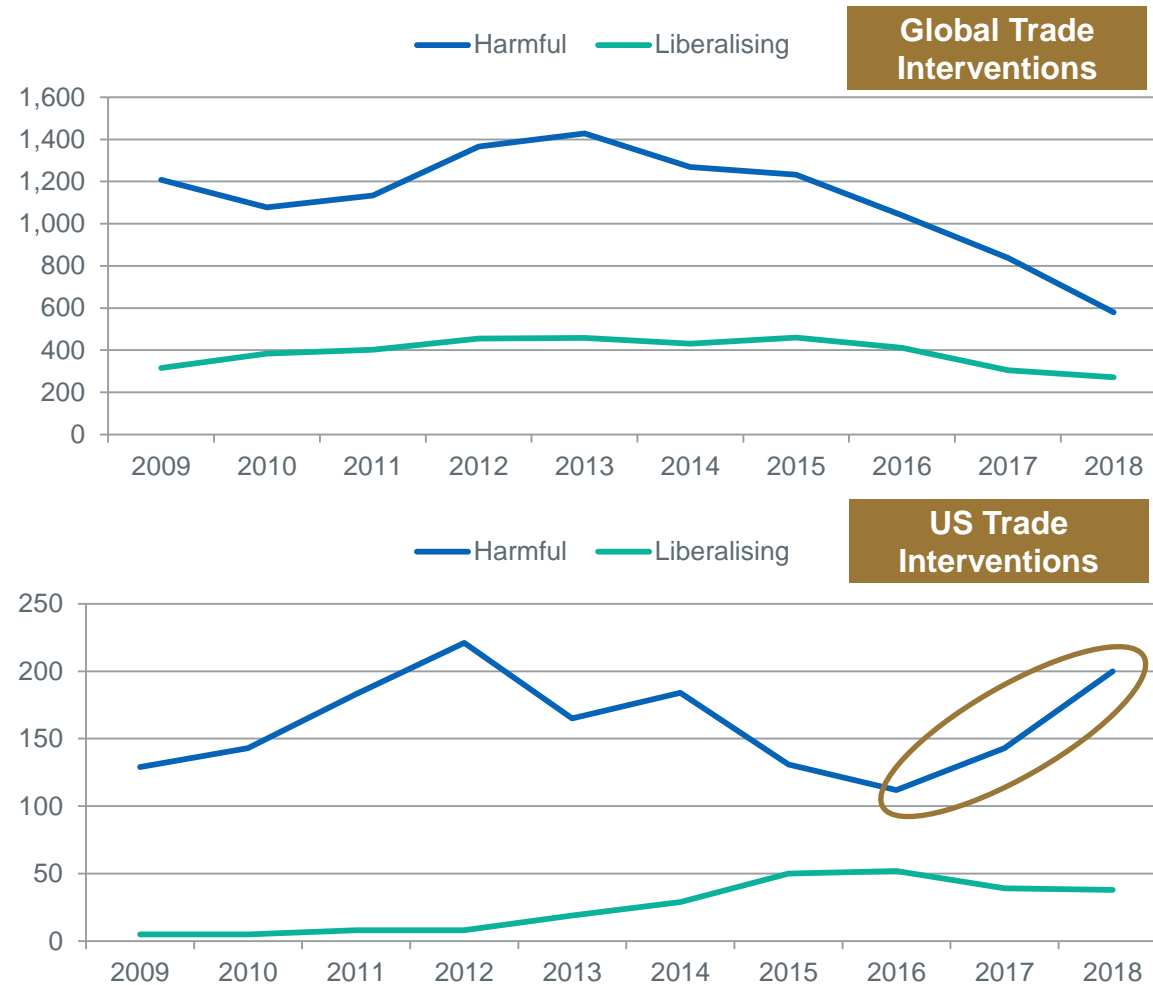
## WTO Trade Disputes at All-Time High

Average of Monthly Active Trade Disputes at WTO



Source: WTO 2018 Annual Report, Global Trade Alert, 30 July 2018

## Global Interventions Down, But US Interventions Up





# Sovereign Ratings & Global Fiscal Update

# Sovereign Rating Trends and Outlooks

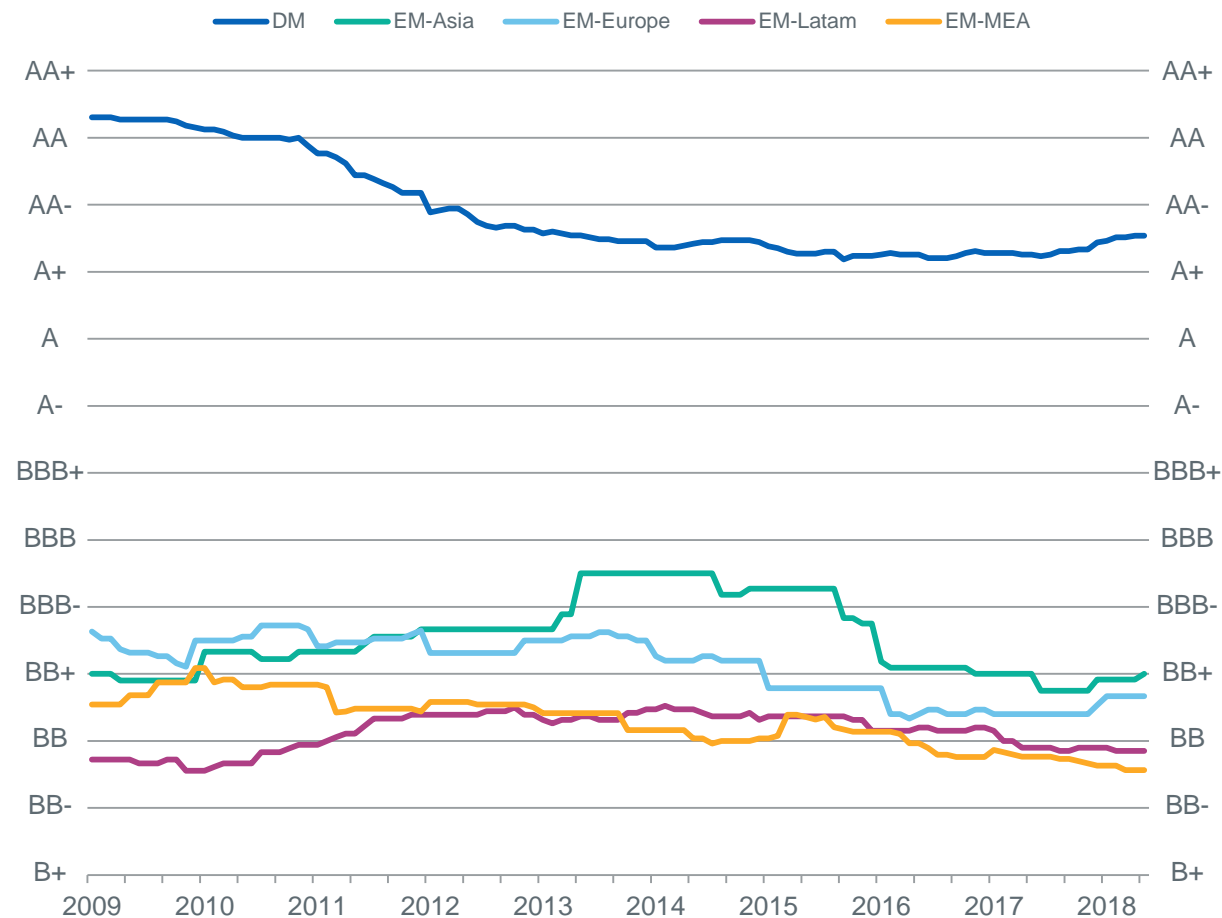
## Negative Outlooks

## Positive Outlook

Developed Markets	San Marino BBB-	Andorra BBB	Czech Republic A+
	UK AA	Austria AA+	Estonia A+
Emerging Asia	Pakistan B	Mongolia B-	Greece B
Emerging Europe	Turkey BB	Armenia B+	Hungary BBB-
		Croatia BB+	Macedonia BB
Latin America	Aruba BBB-	Jamaica B	Russia BBB-
	Costa Rica BB	Paraguay BB	
Middle East & Africa	Ecuador B		
	Nicaragua B		
	Gabon B	Oman BBB-	Egypt B
	Nigeria B+	Tunisia B+	
	Zambia B		

## DM Ratings Move Higher, EM Stabilisation

### Average Ratings by Region

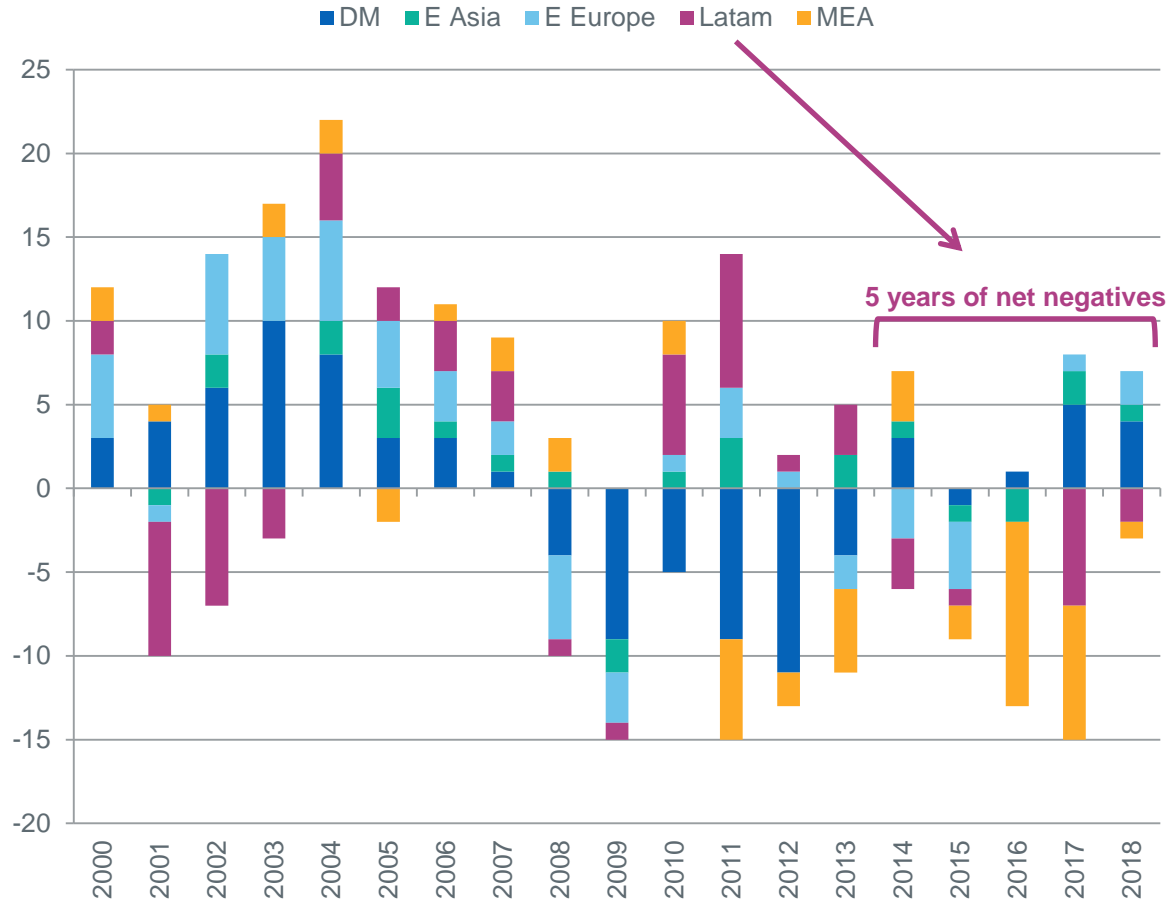


Source: Fitch, 30 July 2018

# Sovereign Rating Trends and Outlooks – Latin America

## Latam – the Longest Period Without Net Positive Rating Actions

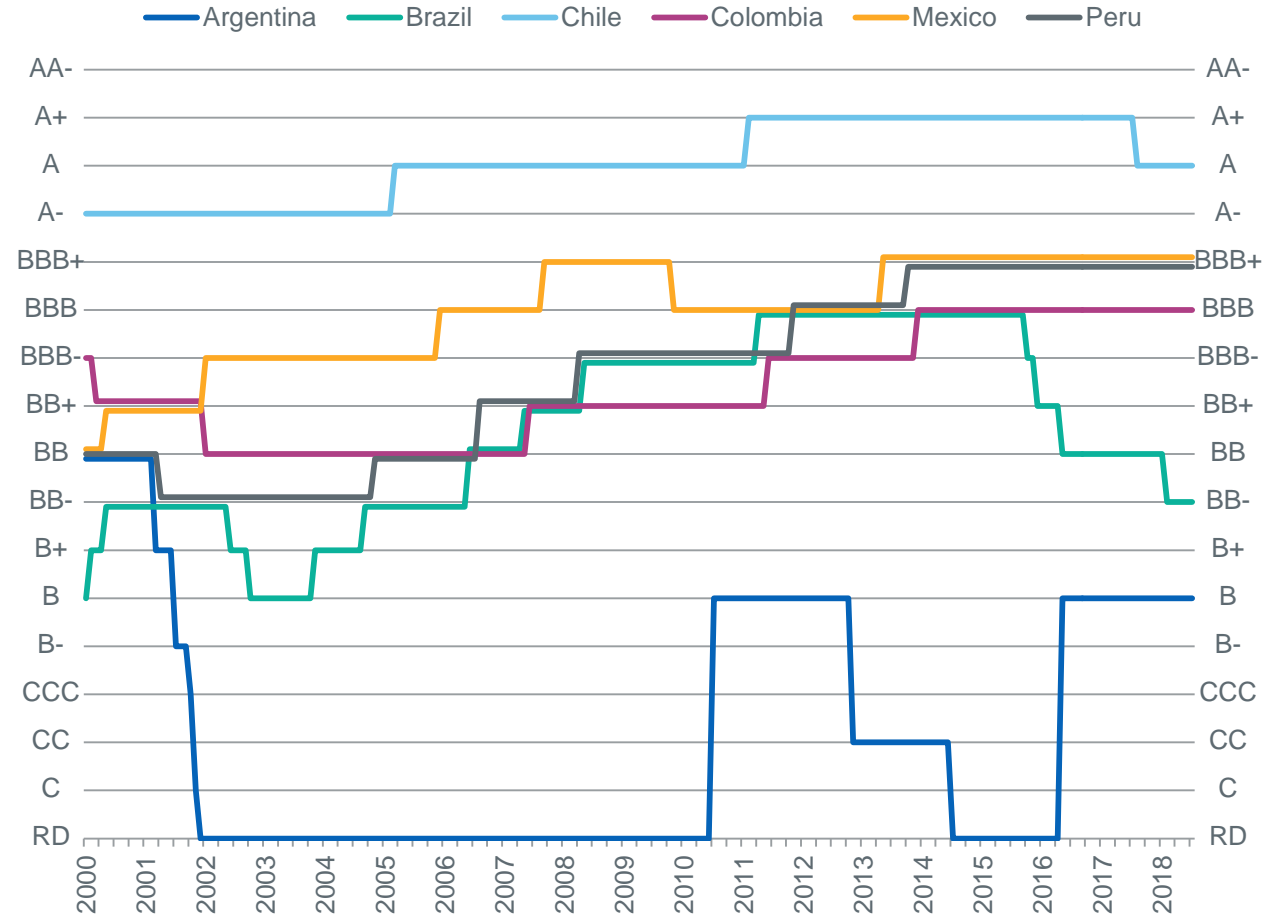
### Net Rating Upgrades by Region



Source: Fitch, 30 July 2018

## Brazil Has Lost Considerable Ground

### Select Latin American Sovereign Ratings



# Sovereign Rating Trends and Outlooks

## More Upgrades than Downgrades in 2018

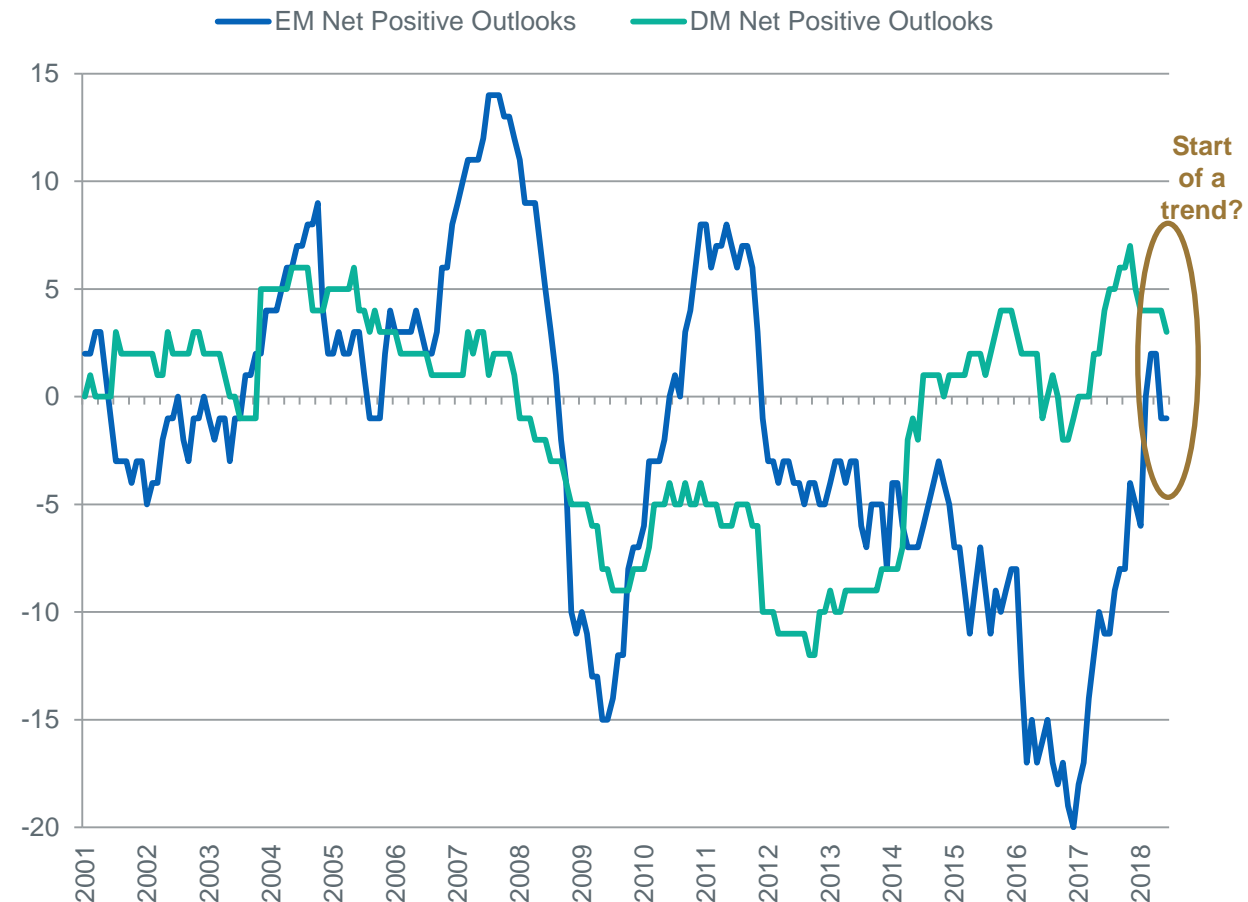
### Global Upgrades and Downgrades

- **2018 Upgrades**
  - Belarus B
  - Croatia BB+
  - Cyprus BB+/Positive
  - Greece B/Positive
  - Macao AA
  - Spain A-
  - Vietnam BB
- **2018 Downgrades**
  - Bahrain BB-
  - Brazil BB-
  - Nicaragua B/Negative
  - Turkey BB/Negative

Source: Fitch, 30 July 2018

## Rating Outlook Cycle Has Turned Lower

### Net Positive Rating Outlooks

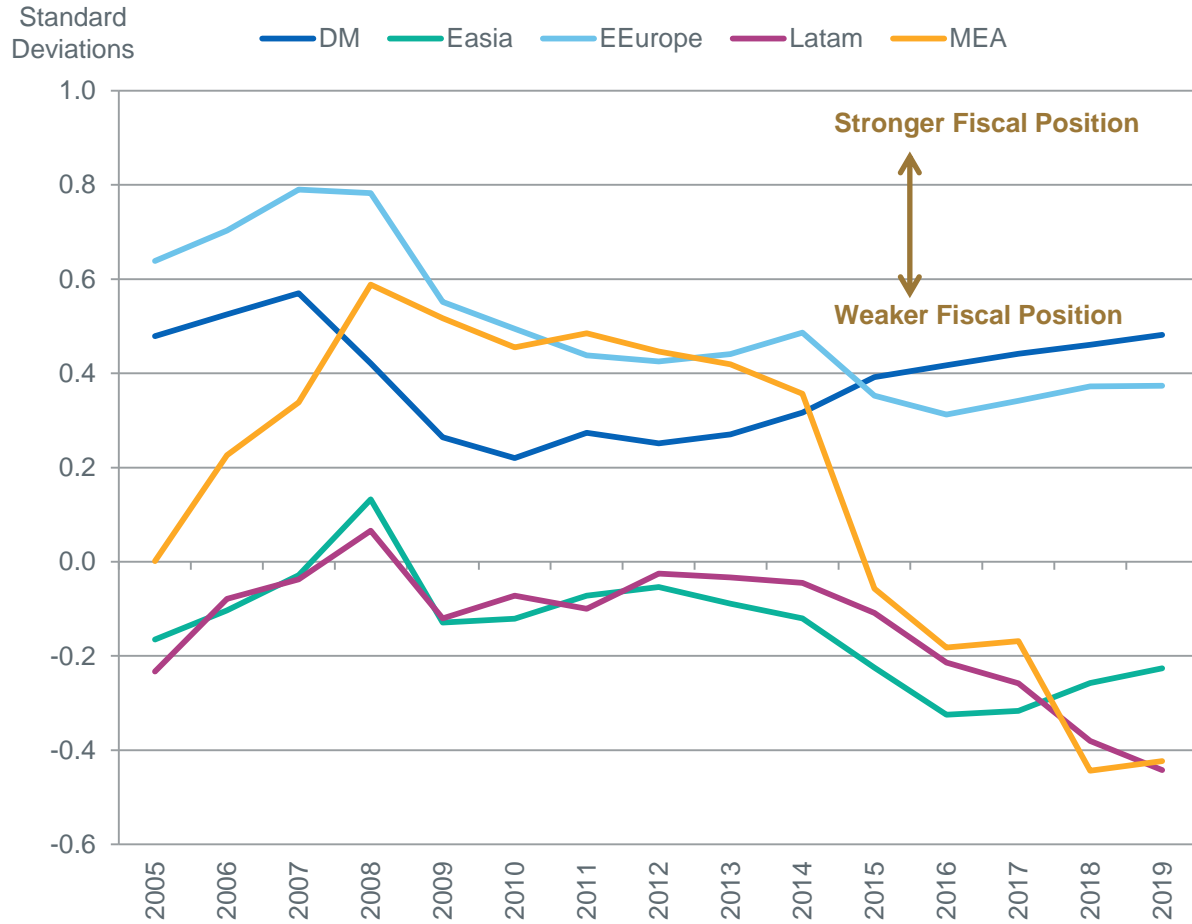




# Global Fiscal Update – Fiscal Index: MEA and Latam Not Improving

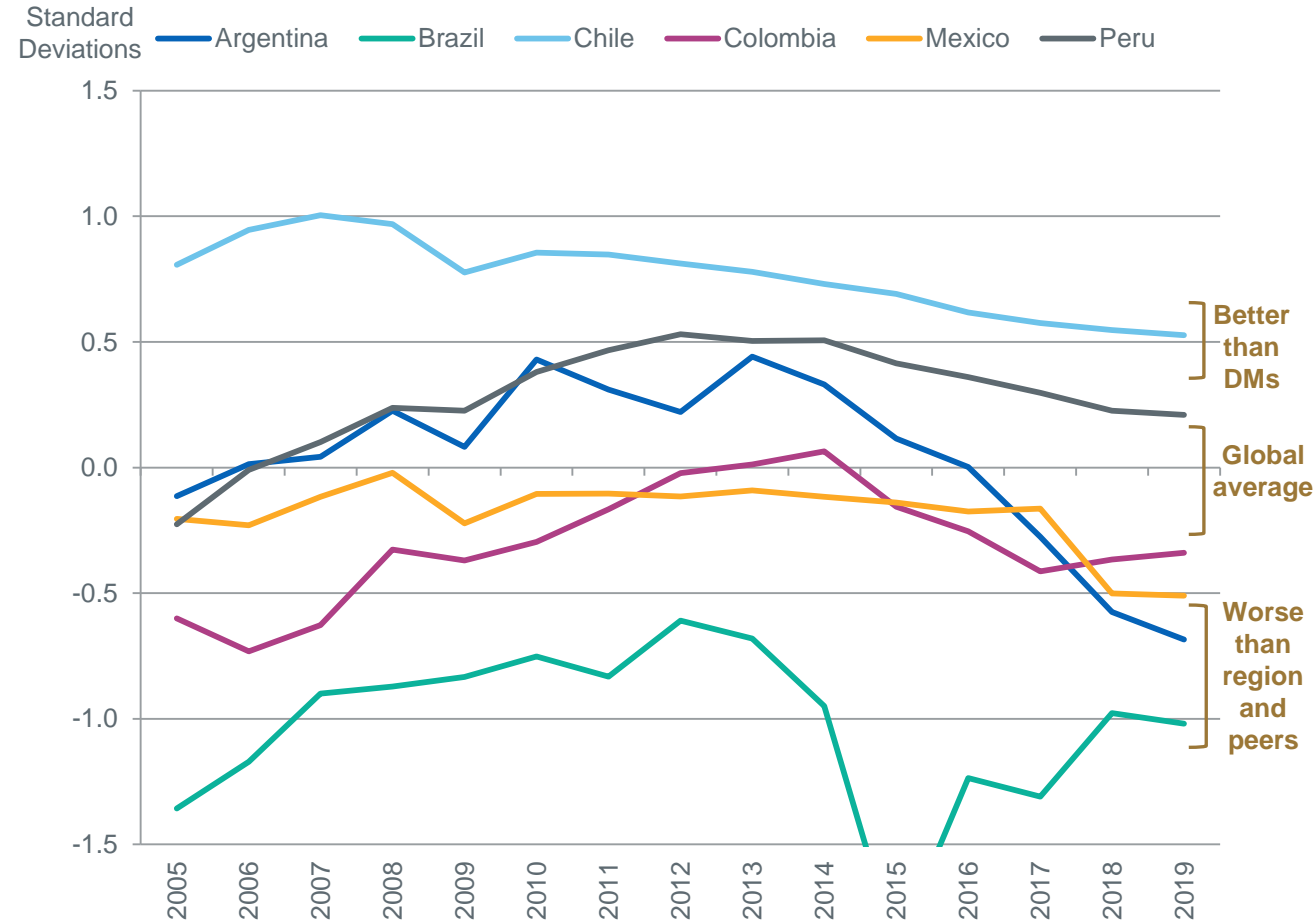
## Latin America Still Deteriorating

Sovereign Rating Model Fiscal Median Scores by Region\*



## Big Variations in Fiscal Scores in Latam

Sovereign Rating Model Fiscal Scores by Country\*

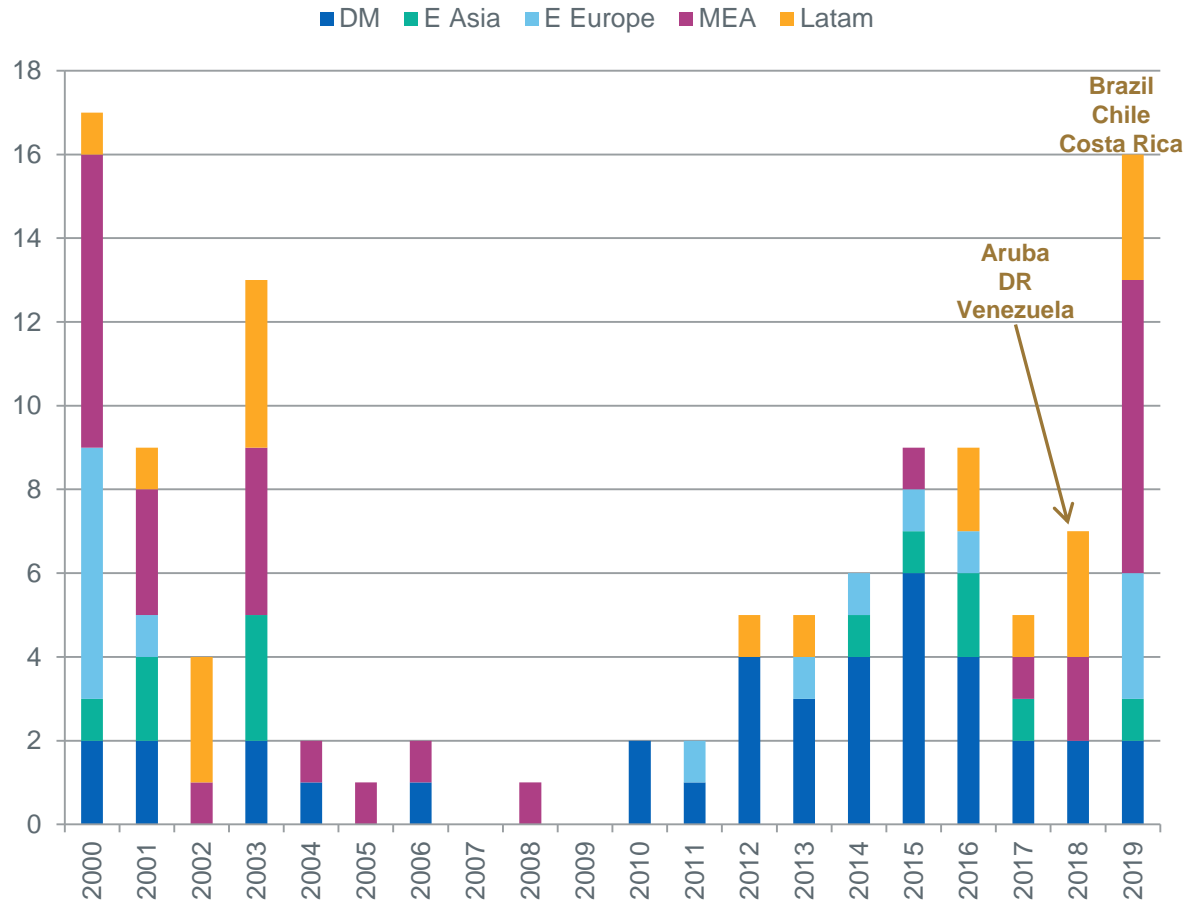


\* Zero is average global fiscal score in the Fitch Sovereign Rating Model over the period 2005-2019; Sources: Fitch, 30 July 2018

# Global Fiscal Update – Debt Levels Still Rising

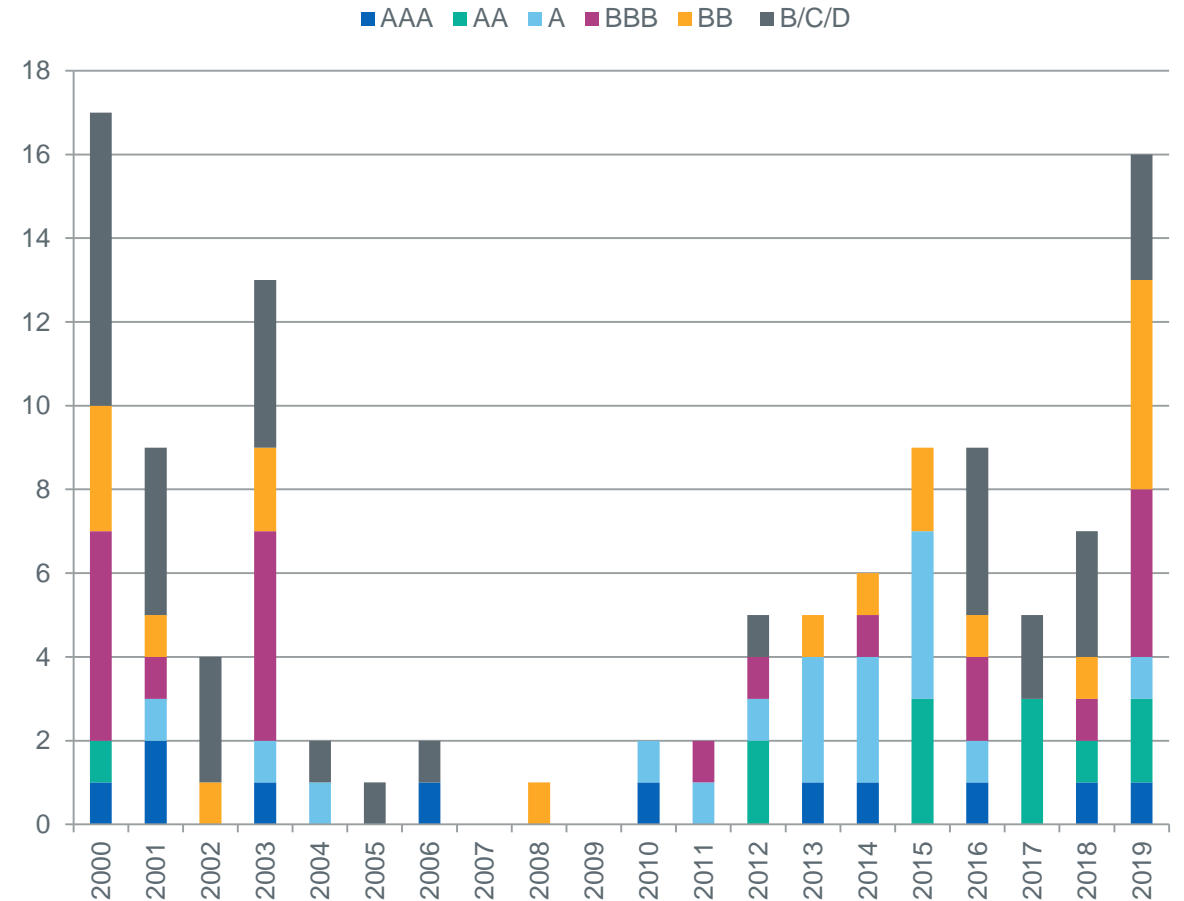
## Government Debt Rising in Middle East & Africa and Latam

Number of Sovereigns in Which Debt/GDP Peaks 2000-2019



## Government Debt Rising in BB and BBB Categories

Number of Sovereigns in Which Debt/GDP Peaks 2000-2019



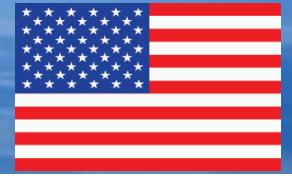
Sources: Fitch, 2 July 2018



## Country/Regional Considerations

# United States – How Robust is the AAA?

AAA/Stable



## Despite Weak Public Finances, a Solid AAA

### Sovereign Rating

#### AAA/Stable

- Weak public finances will get weaker, but structural and external strengths are likely to persist

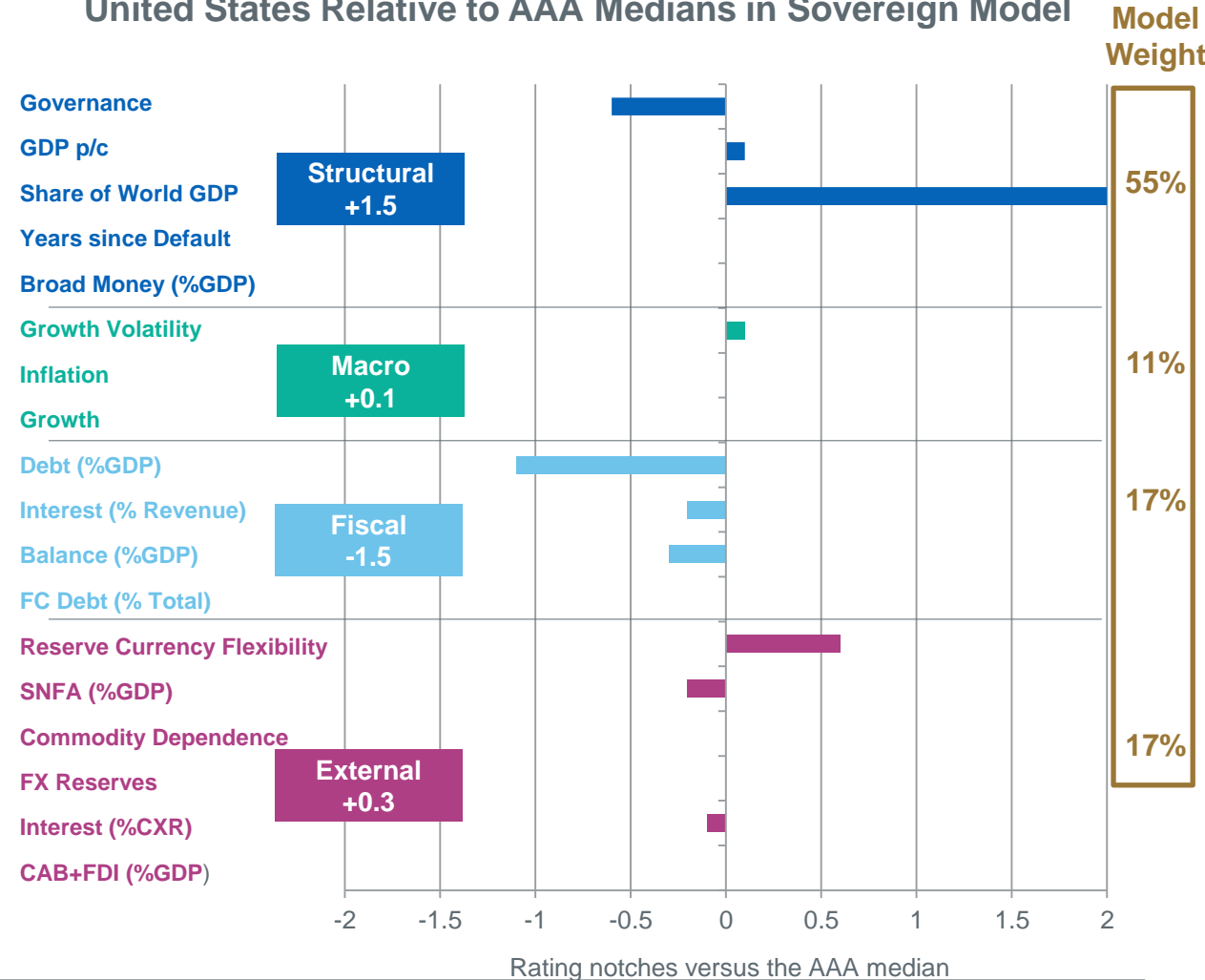
### According to Fitch's Sovereign Rating Model:

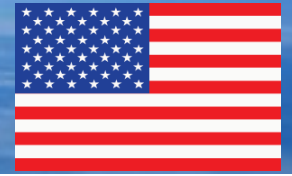
- The US is one of the stronger AAAs (Norway and Switzerland are strongest in the model)
- US **public finances** are a distinct weakness, with the highest debt/GDP ratio among AAA peers
- US **structural features** are a rating strength, derived from the share in world GDP
- Reserve currency flexibility adds 2.3 notches to the US rating, which is 0.6 notches more than the AAA median
- Fiscal deterioration needed to lose AAA in the model:**
  - Government debt increases by 35% of GDP
  - Government debt increases by 20% of GDP, deficit is 6% and interest payment 11% of revenue (now 7.5%)

Sources: Fitch

## US Scores About 1/3 Notch Better Than AAA Peers

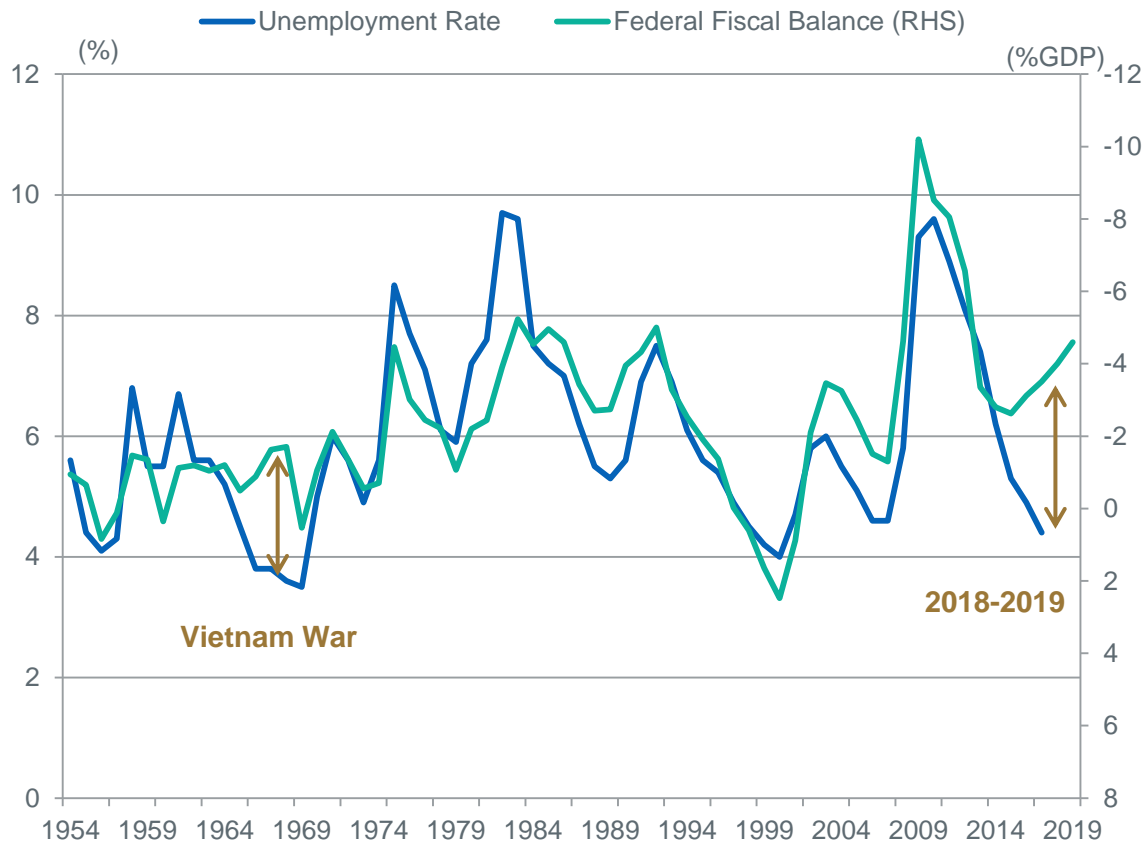
### United States Relative to AAA Medians in Sovereign Model





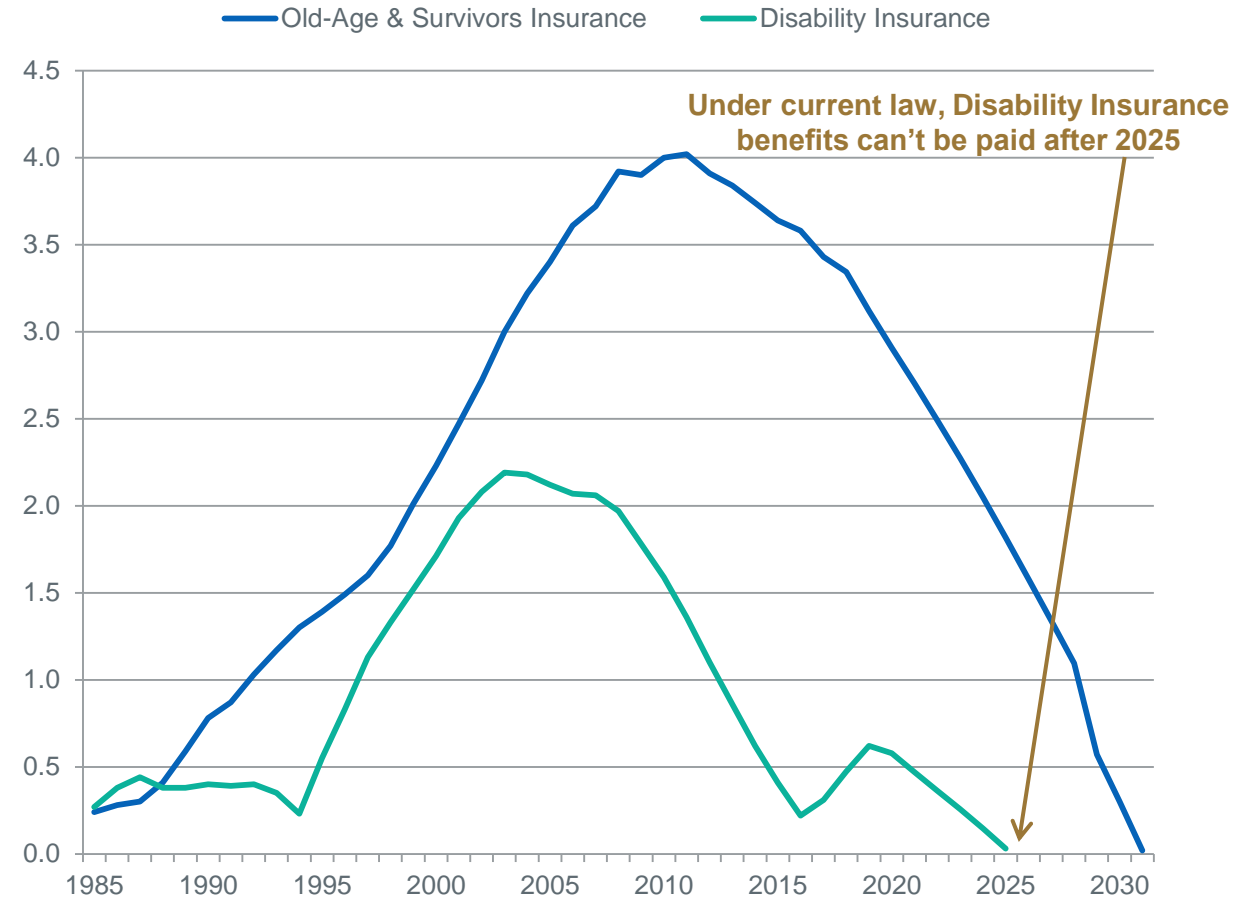
## Fiscal Deficit Biggest Ever By One Measures of the Cycle

### Federal Fiscal Balance Versus the Unemployment Rate



## When Might Mandatory Spending be Addressed? Early 2020s?

### Social Security Trust Fund Ratios (Balance / yearly outflow)



Sources: Congressional Budget Office (April 2018), Datastream, Fitch

# United Kingdom – Nothing Resolved on Brexit

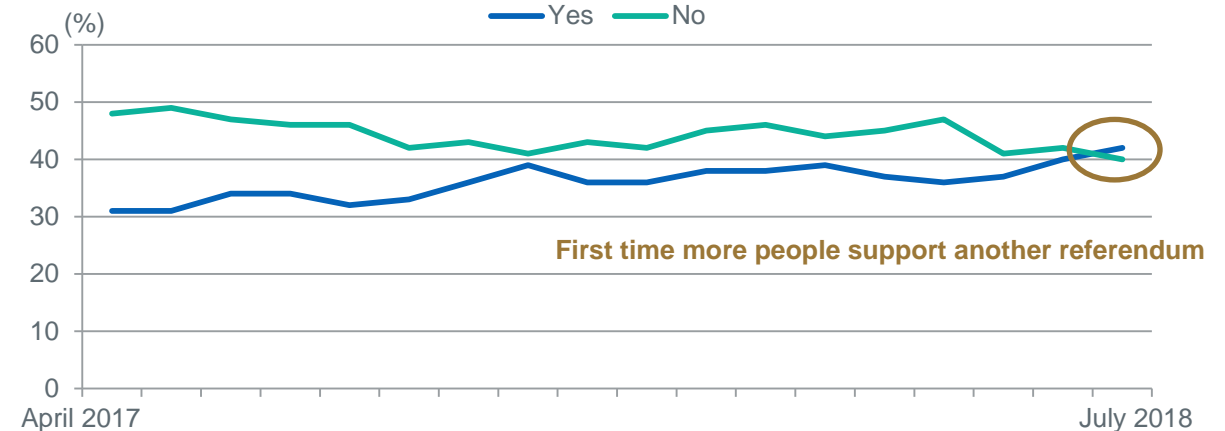
AA/Negative



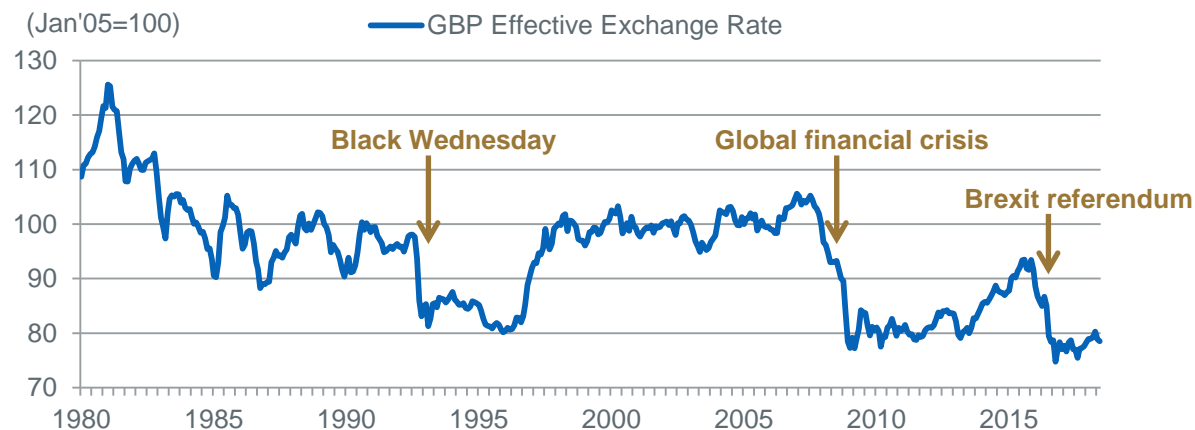
## What is a Reasonable Base Case Expectation?

- **The full spectrum of possible outcomes remains:**
  - Free trade agreement (goods), transition period to end-2020
  - Another vote:
    - Referendum – outcome unclear
    - Election – outcome unclear
  - Hard Brexit, with no deal by March 2019

## Should There Be Another Referendum?

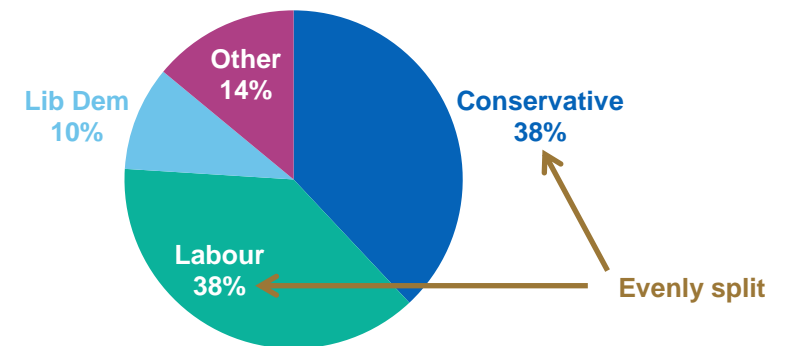


## Exchange Rate Effect of Historic Proportion



Sources: Datastream, YouGov, Fitch, 30 July 2018

## Voting Intentions if There Were an Election



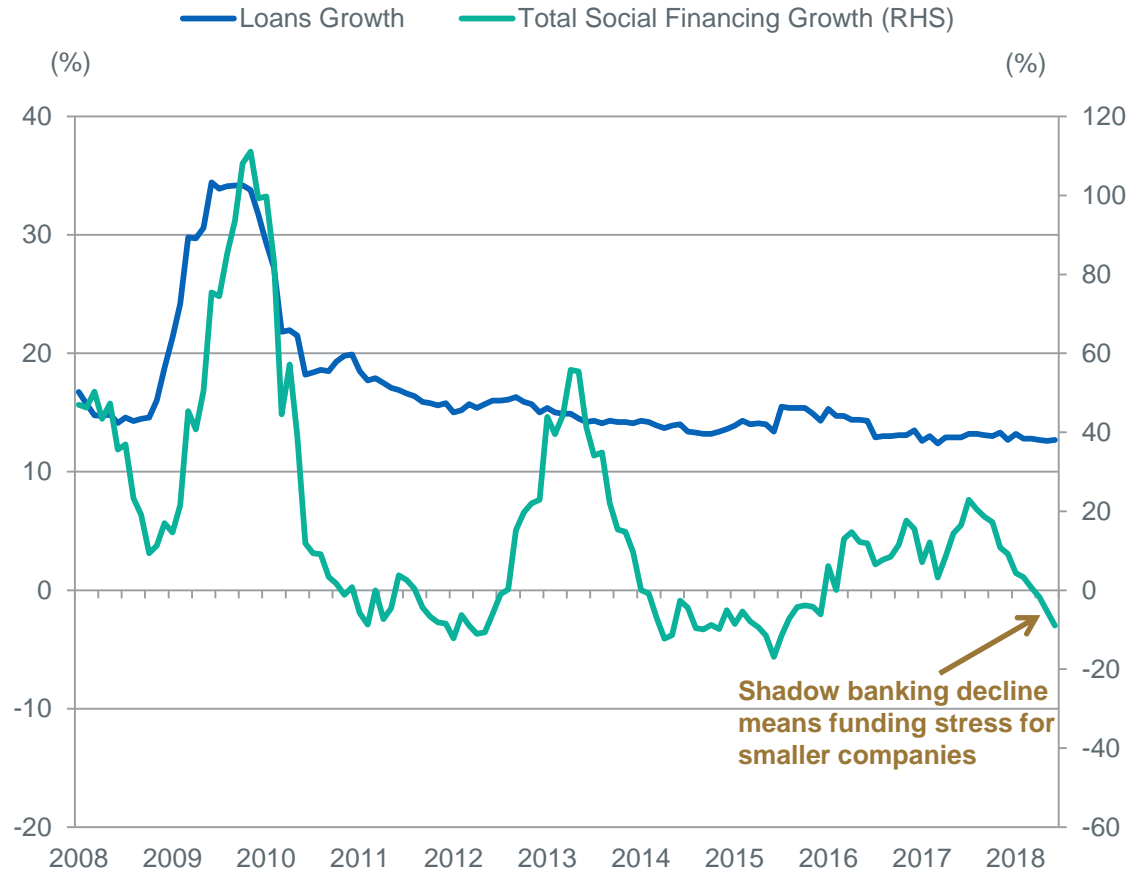
# China – Is Leverage Still Growing or Not? Yes, Traditional Bank Lending

A+/Stable



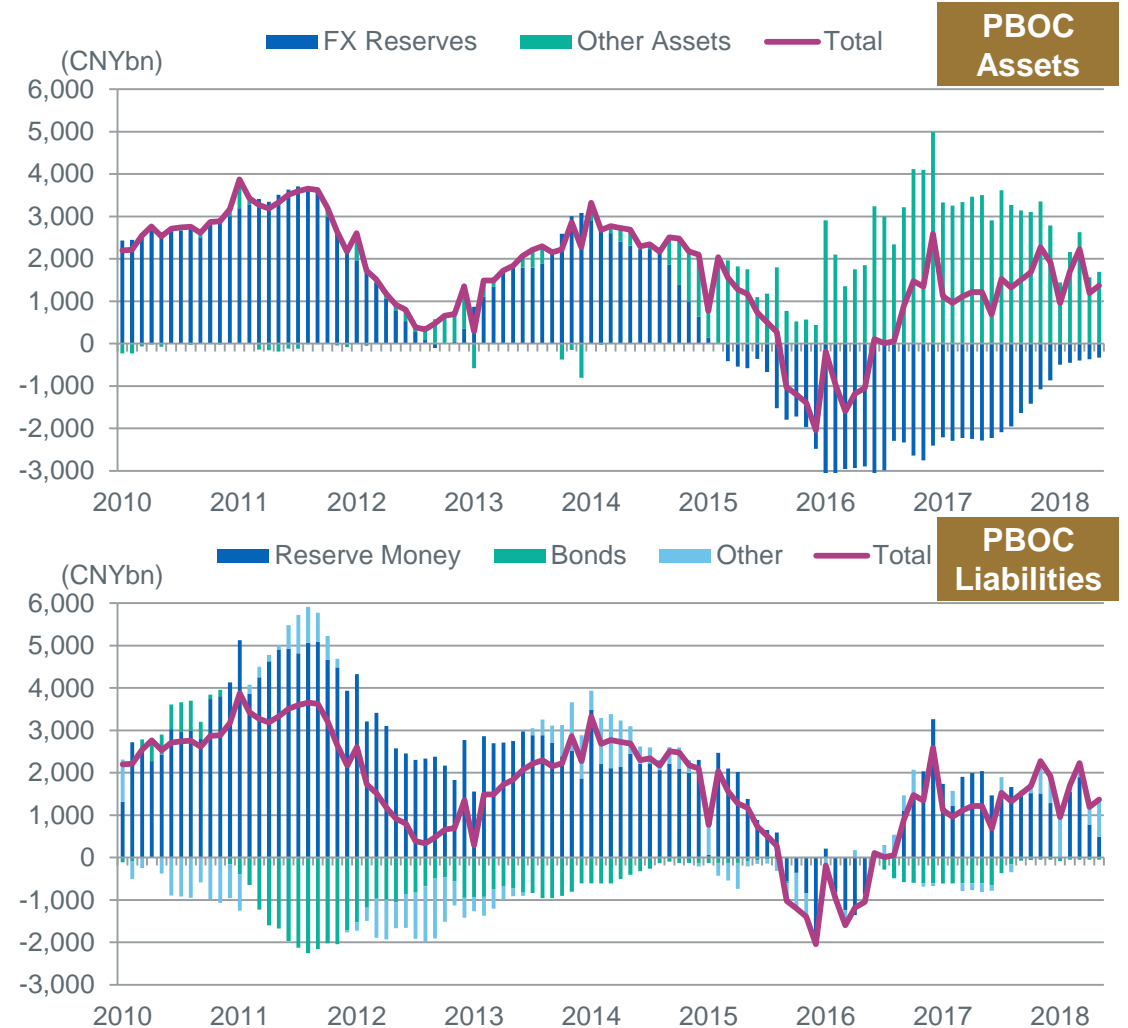
## Bank Loans are Growing, Other Financing is Contracting

### Loan Growth and Total Social Financing Growth



Sources: Fitch and Datastream, 30 July 2018

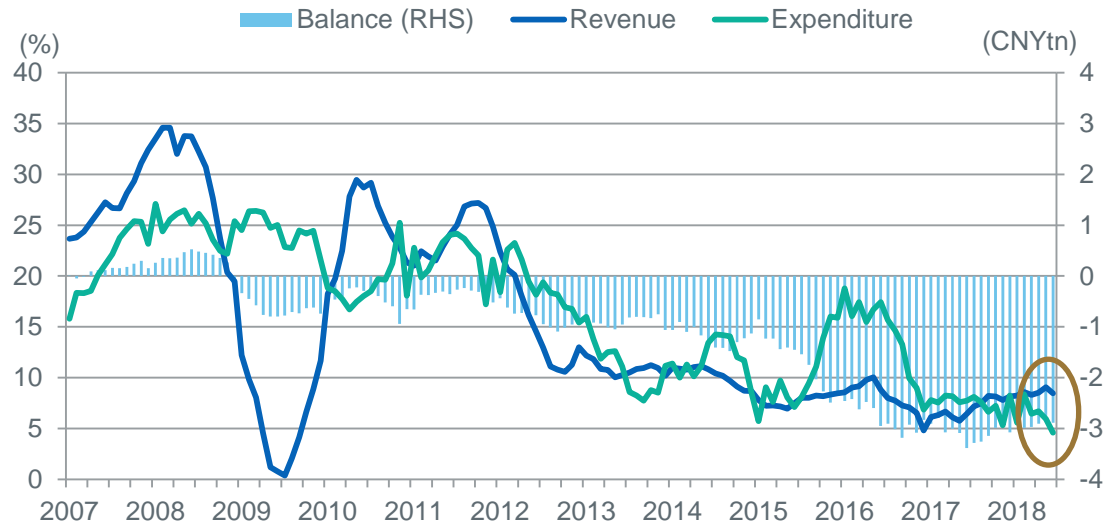
## PBOC Asset Growth is Lending to Banks, Not FX Reserves





## Fiscal Position Improving: On-Budget Expansion is Possible

### Chinese Fiscal Balance

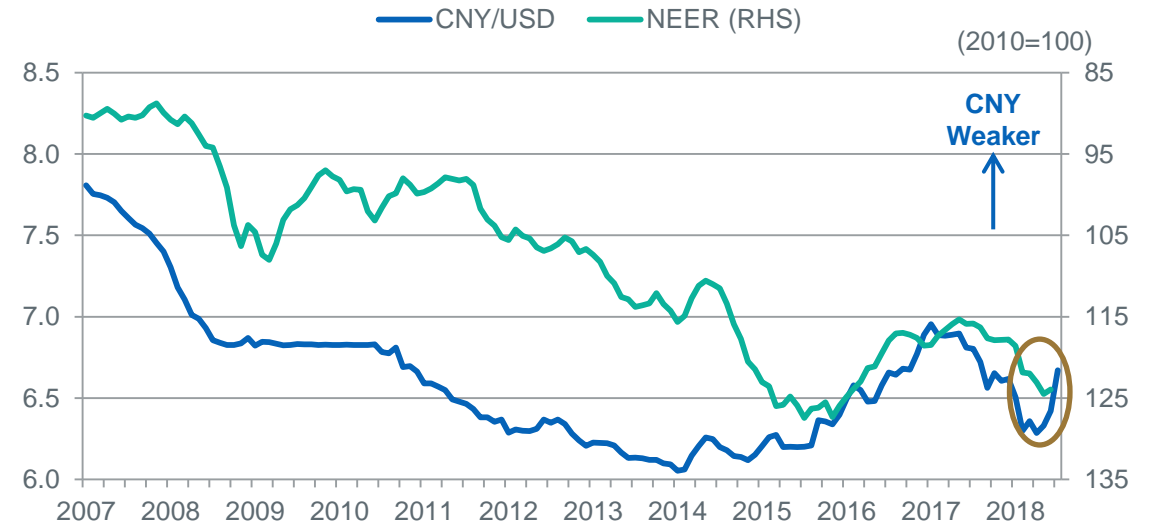


- Being a “moderately prosperous society” by 2021, means GDP per capita of USD10,000
- Growth rates of about 6.5% still needed to achieve the goal
- There is scope for fiscal expansion

Sources: Fitch and Datastream, 30 July 2018

## Very Sharp Fall in CNY versus Dollar

### Chinese Exchange Rate



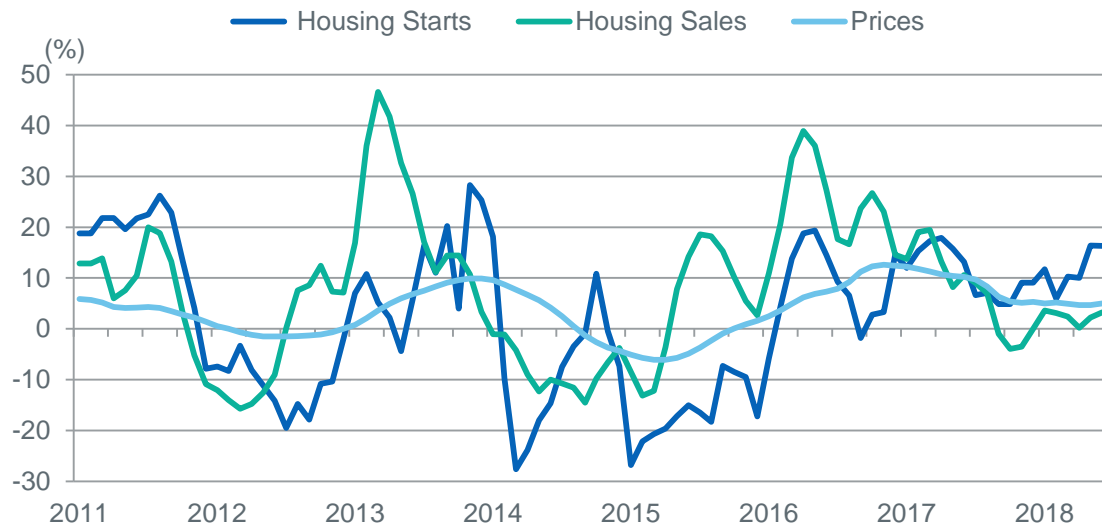
- The exchange rate is not the preferred option, since depreciation brings higher inflation and may lead to capital outflows – and further depreciation
- But the currency has appreciated over the last 10 years
- Modest depreciation may be expected





## A Modest Housing Recovery Continues into 2018

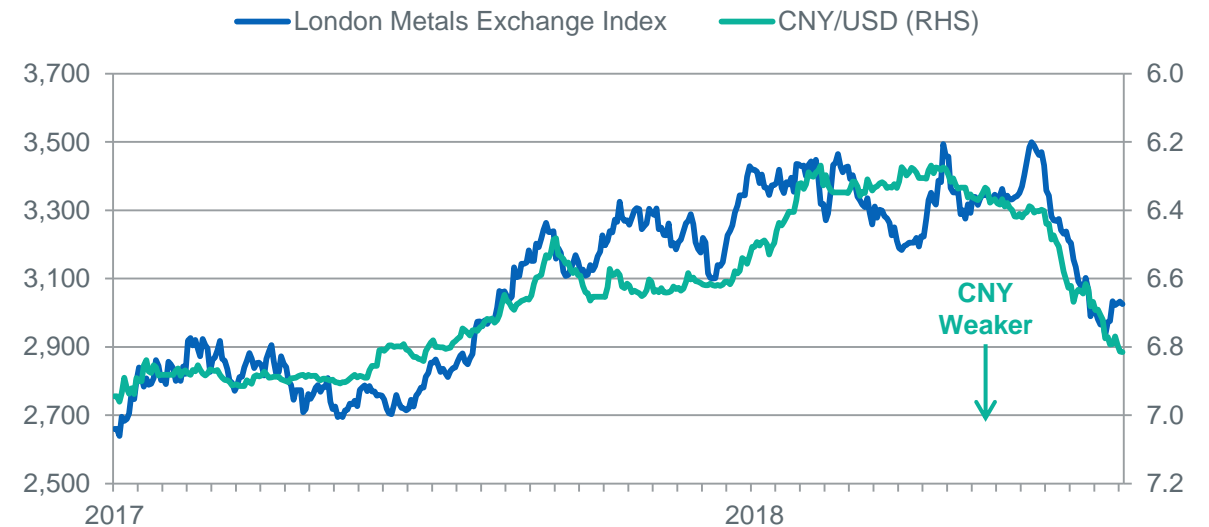
### Housing Starts Proxy



- The housing market in China is likely the most important single sector for the global economy – outlook fairly positive for 2018
- There are clear housing cycles in China, at least since 2011
- Housing tightening cycle evident in 2016 has wound down

## Strong Relationship Between RMB and Global Metals Prices

### Global Metals versus CNY/USD



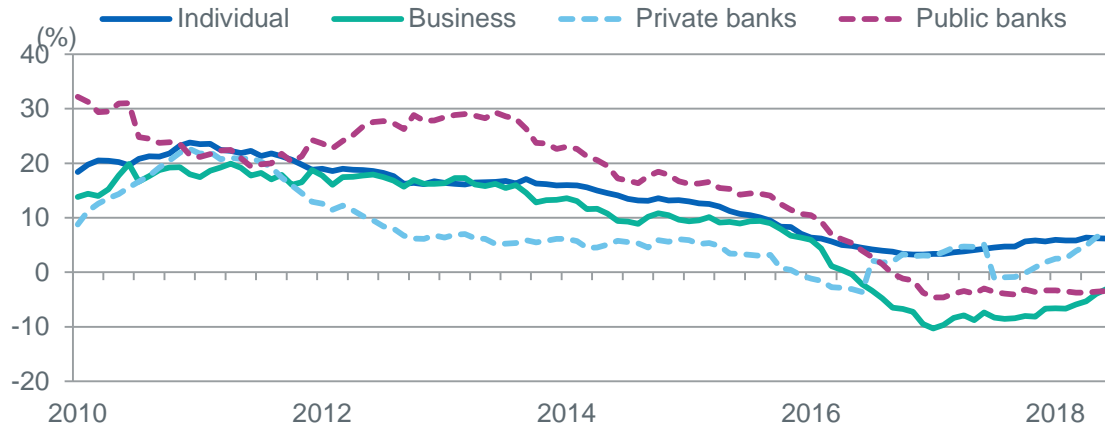
- China accounts for nearly half of global metals demand (average for steel, copper and aluminium)
- Metals prices may be one consideration for policymakers with respect to the exchange rate; metals are an important input, and the price in CNY terms is held steady

# Brazil – Rating is All About Fiscal Trajectory

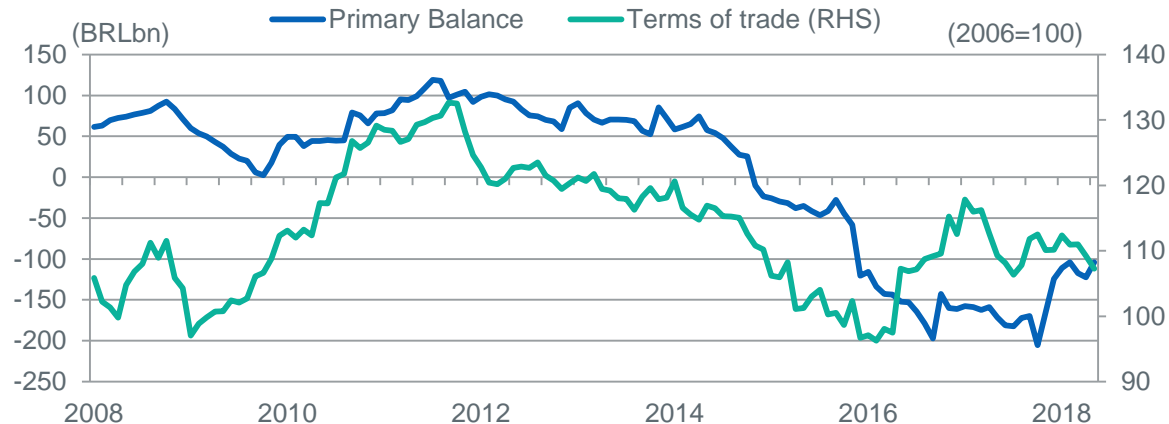
BB-/Stable



## Credit Growth – Bottomed Out Last Year



## Asymmetric Fiscal Shock – Terms of Trade Better, Fiscal Lags



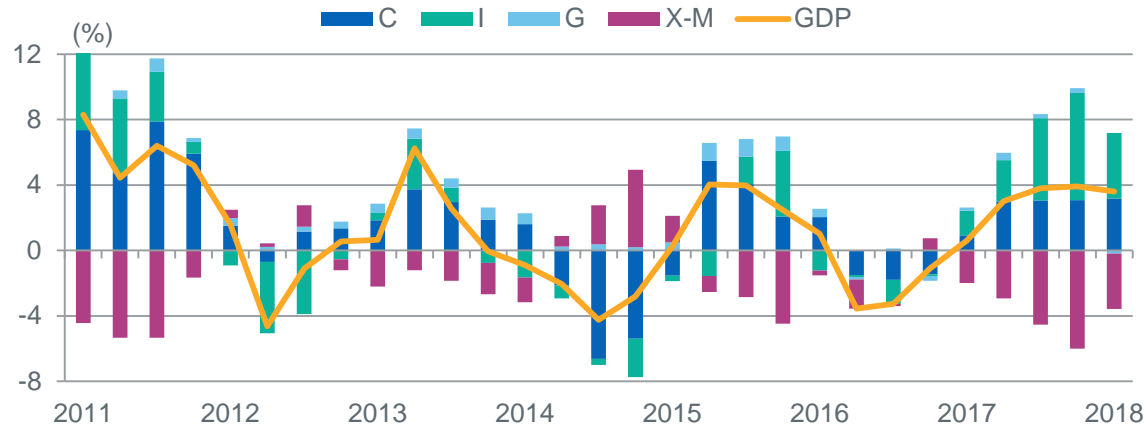
Sources: Fitch and Datastream, 30 July 2018

## Sovereign Rating Sensitivities

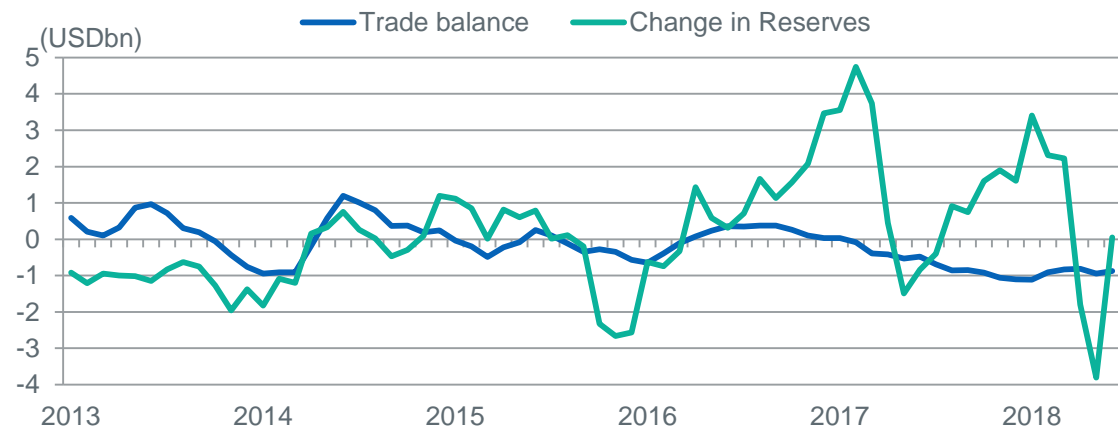
- **What Would Move the Rating Higher?**
  - Improved political environment that facilitates policy initiatives to address MT public debt sustainability
  - Fiscal consolidation and improved prospects for debt stabilisation
  - Improved growth outlook amid continued macro stability
- **What Would Move the Rating Lower?**
  - Sustained inertia related to fiscal reform and rapid growth in public debt
  - Deterioration in the sovereign's domestic or external market access conditions
  - Erosion of international reserves and broader external balance sheet



## GDP Growth Contributions – Plenty of Volatility



## External Flows – Sentiment and Capital Flows Volatile



Sources: Fitch and Datastream, 30 July 2018

## Sovereign Rating Sensitivities

- **What Would Move the Rating Higher?**
  - Improved outlook for growth and inflation
  - More consistent policy framework and reform progress
  - Fiscal consolidation and favourable financing access
  - Sustained strength in external liquidity
- **What Would Move the Rating Lower?**
  - Fiscal slippage and/or re-emergence of fiscal financing constraints
  - Erosion of international reserves

# EM – The Importance of the Dollar

## Strong Dollar and Four EM Challenges

### Higher Debt Service in Local Currency Terms

Lots of EM foreign-currency borrowing since 2007 and most EM external debt is dollar-denominated

### Lower Commodity Prices

Usually, a strong dollar is correlated with lower commodity prices, although the relationship does not always hold (such as now)

### Ambiguous Impact on Economic Growth

Net trade is better, but investment spending is import-intensive

### Central Bank Reserves are Likely to Fall

EM central banks resist currency depreciation, using FX reserves to do so

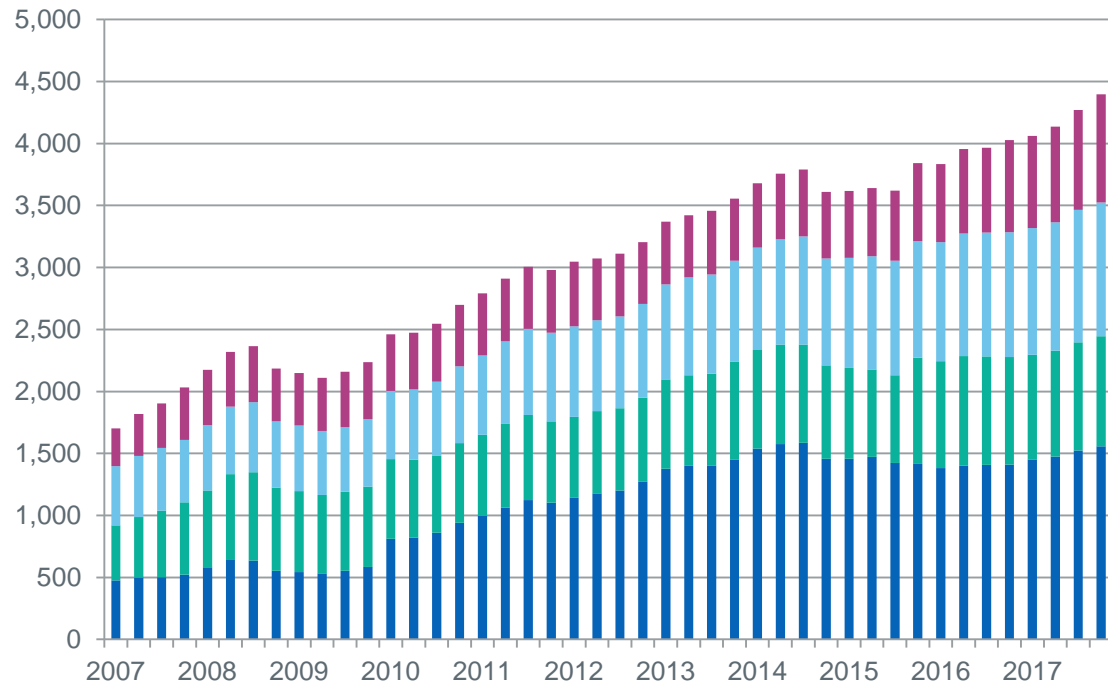
# EM – The Importance of the Dollar

## Dollar Debt Doubled in the Last Decade

Emerging Market Dollar Debt (Corporates + Government / Bonds + Securities / Domestic + External)

EM Asia EM Europe Latam MEA

(USDbn)



Total \$2 trillion → \$4.4 trillion (+100%)  
 Latam \$500 billion → \$1 trillion

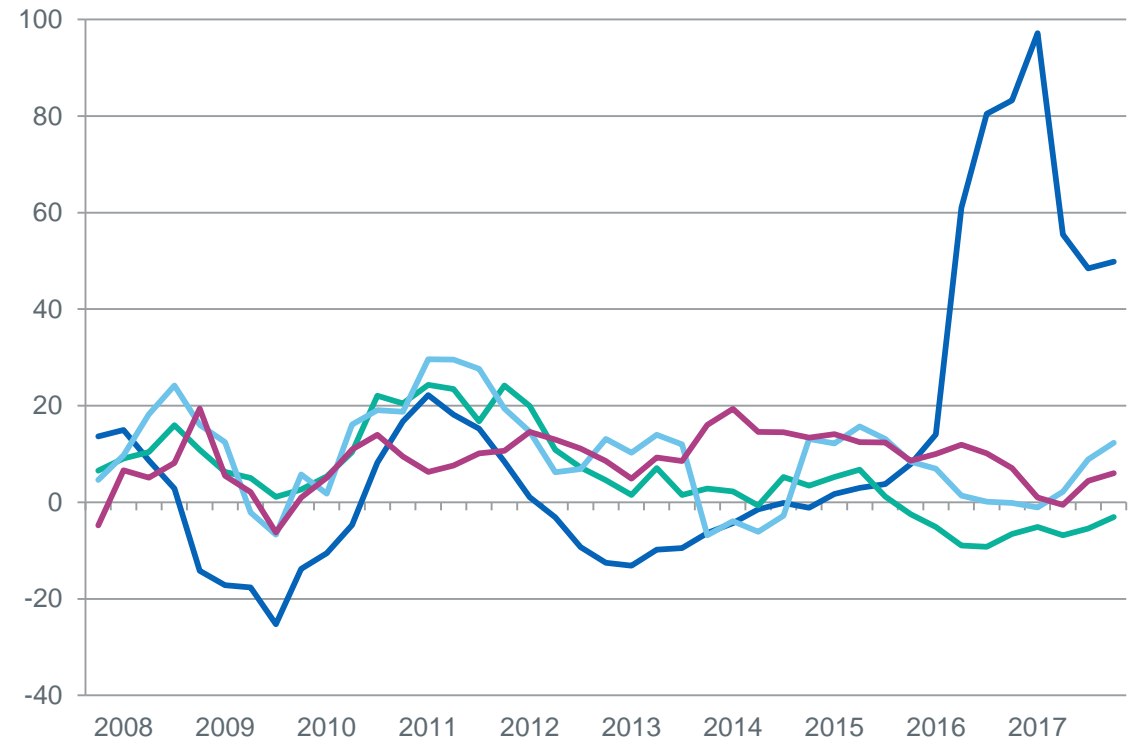
Sources: Fitch, Datastream, BIS, 2 July 2018

## Dollar Debt Grew About 9%/year in Latam Over the Last Decade

Growth Rates of Dollar-Denominated Debt

Argentina Brazil Chile Mexico

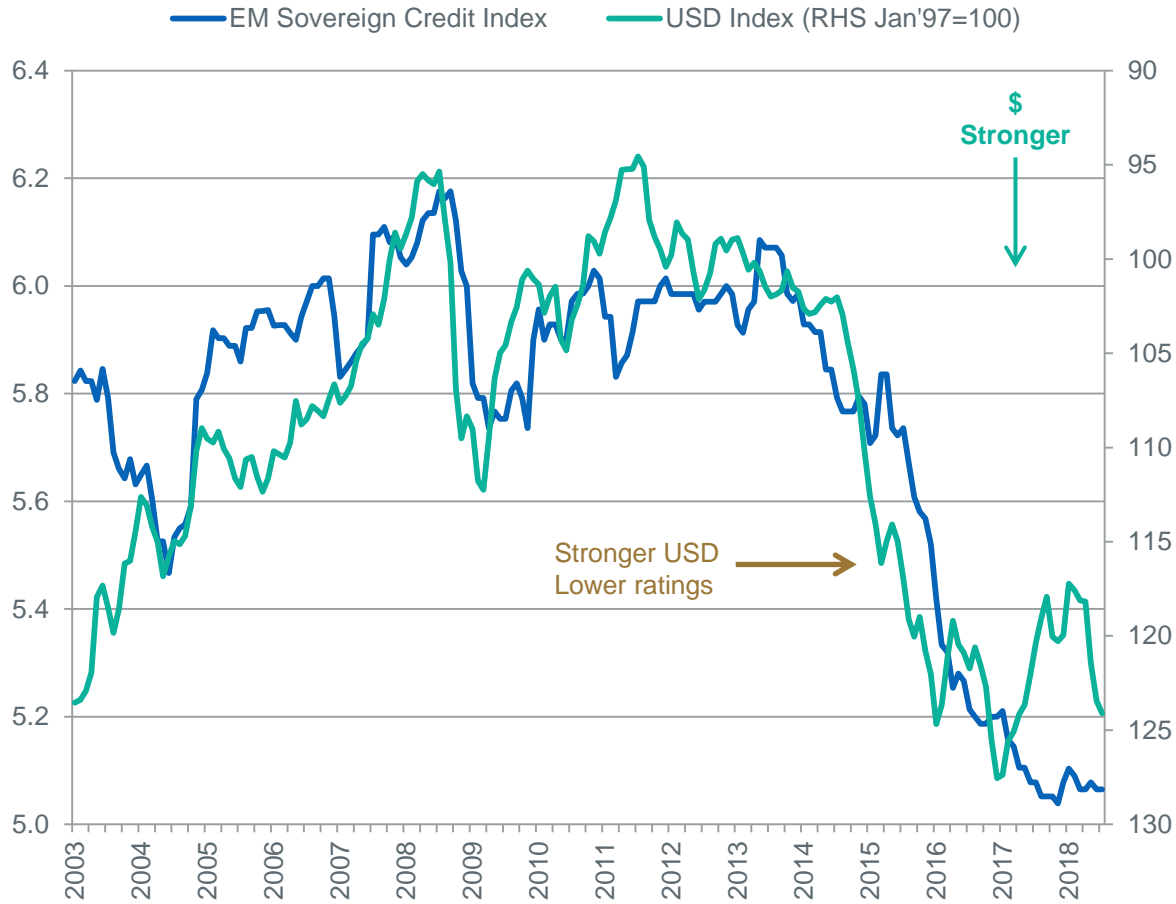
(%)



# EM – The Importance of the Dollar

## EM Sovereign Ratings Correlated With the Dollar

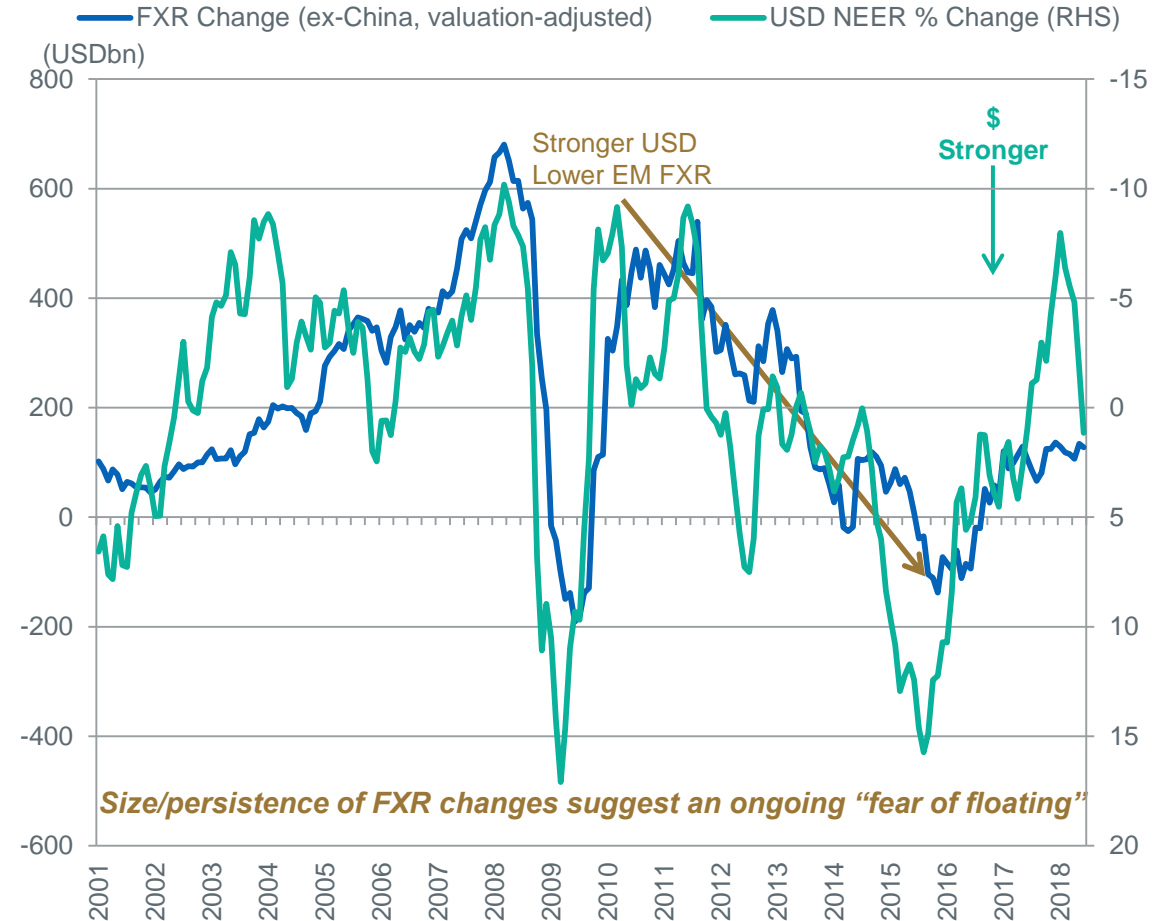
### Emerging Market Sovereign Ratings and Nominal Dollar Index



Sources: Fitch, Datastream, 2 August 2018

## Dollar Strengthens, EM Central Banks Lean Against the Trend

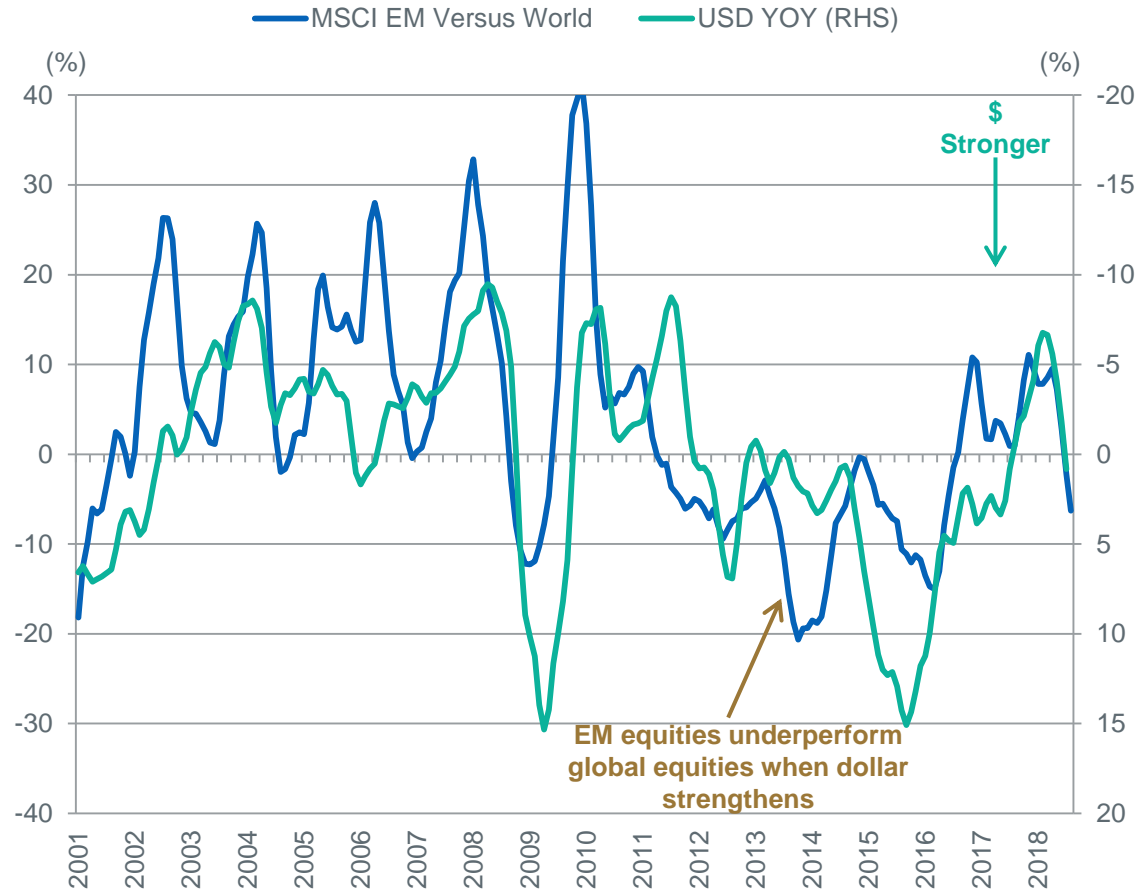
### Changes in FXR (yoy) and Changes in NEER (yoy%)



# EM – The Importance of the Dollar

## EM Equities Perform Worse With a Strong Dollar

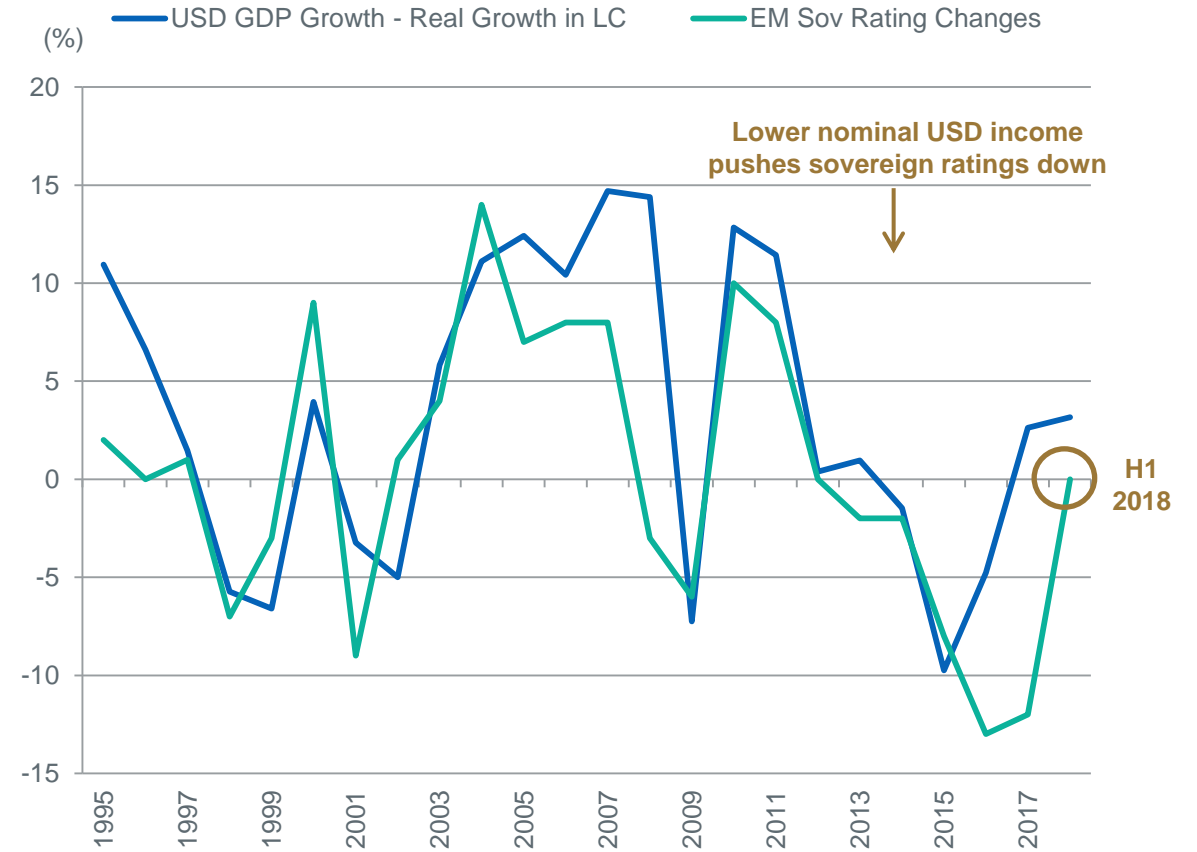
Y/Y Return on EM versus Global Equities, and the US Dollar



Sources: Fitch, Datastream, IMF WEO, 2 August 2018

## Weaker Dollar-Denominated GDP = Lower Ratings

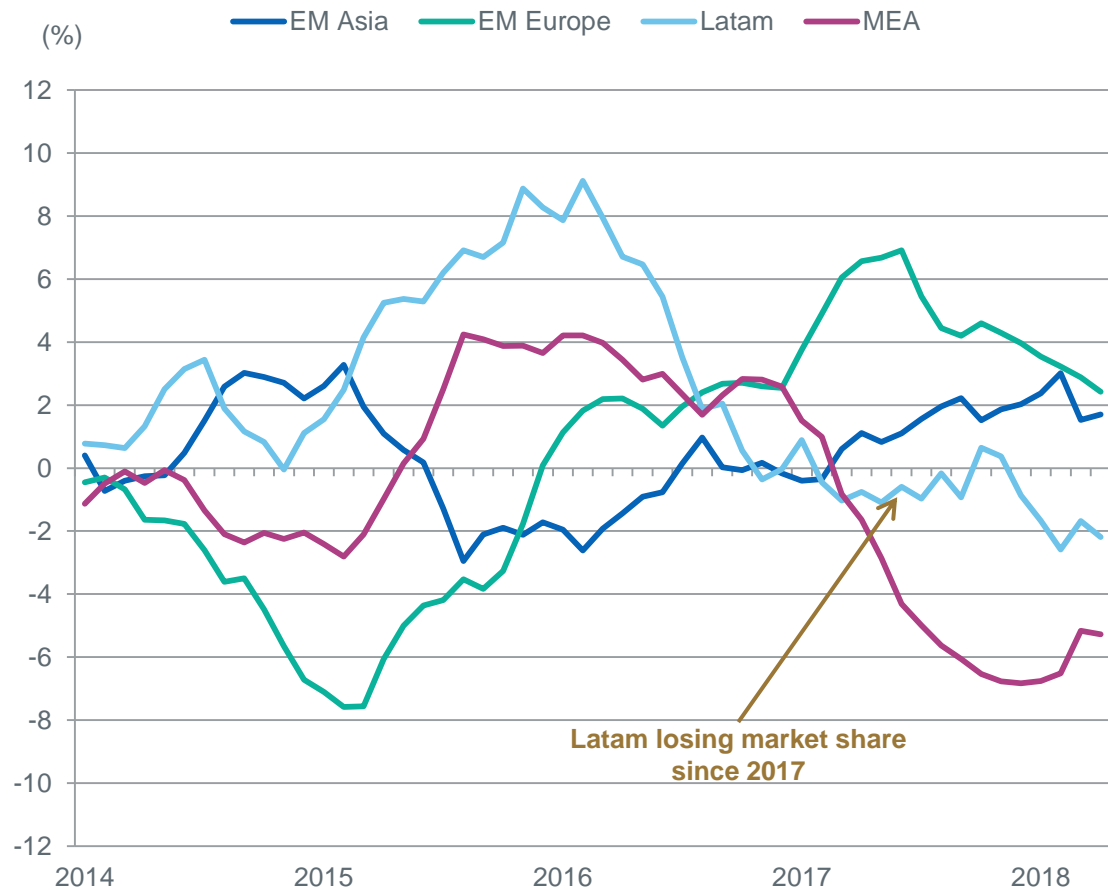
Gap: Growth USD Nominal GDP & Real Local GDP, and Ratings



# EM – Rating Changes Aligned With Export Market Share Changes

## Relative Export Growth Rates Favour E Europe and Asia

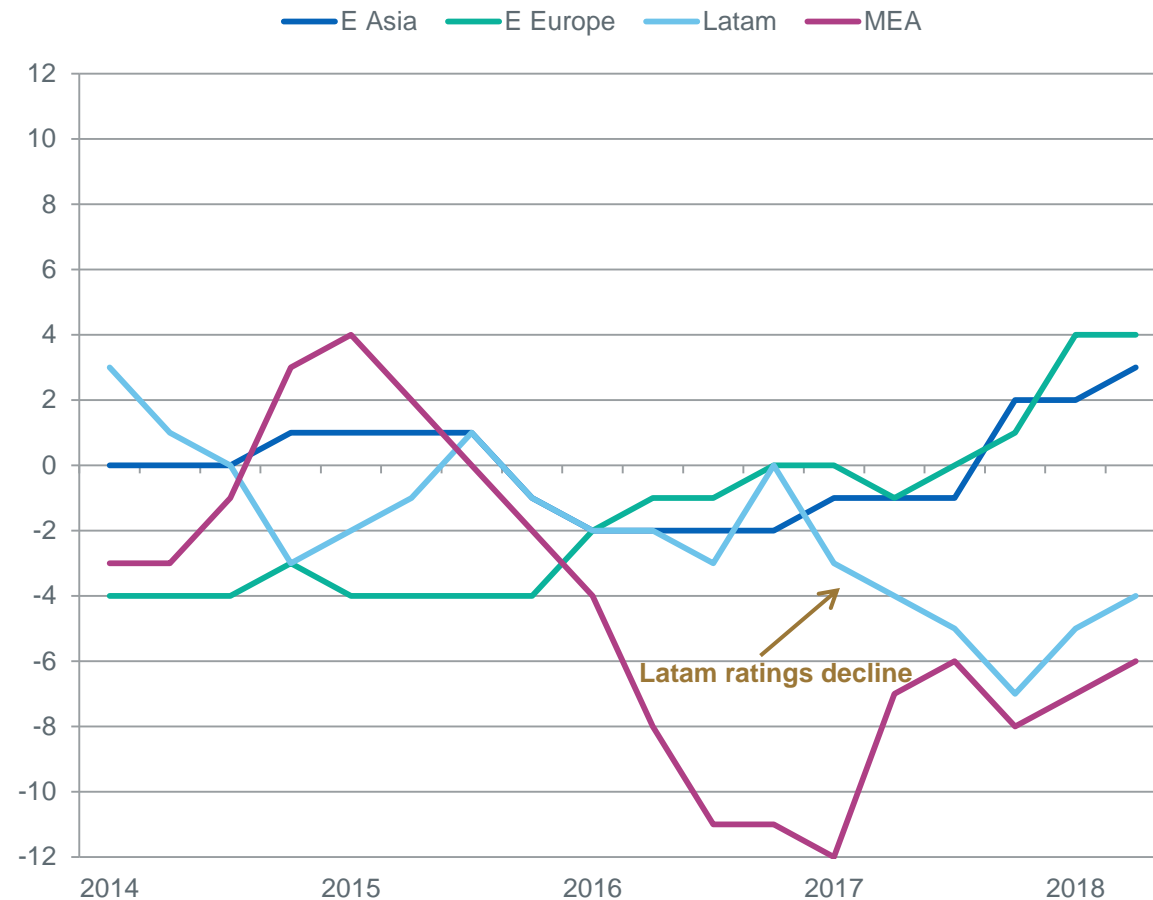
### Regional Export Growth Relative to Global (Volumes)\*



\*6-month trailing averages  
Sources: Datastream, Fitch, 2 July 2018

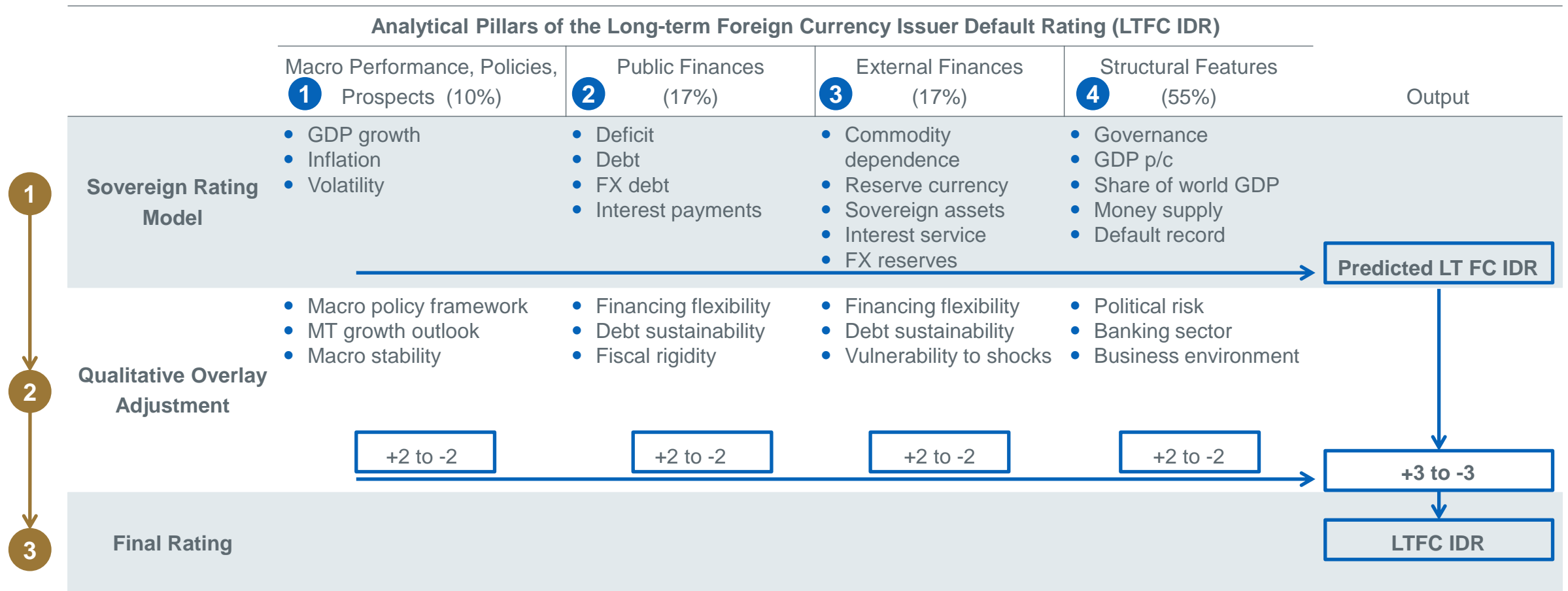
## Positive Rating Momentum in E Europe and Asia

### 4-quarter Trailing Rating Actions



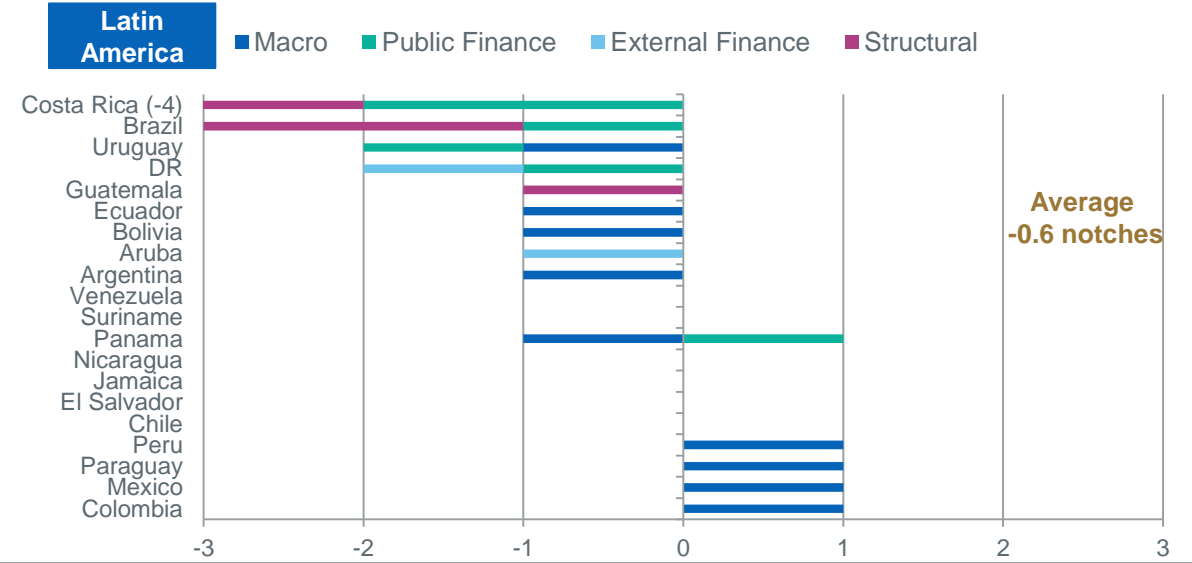
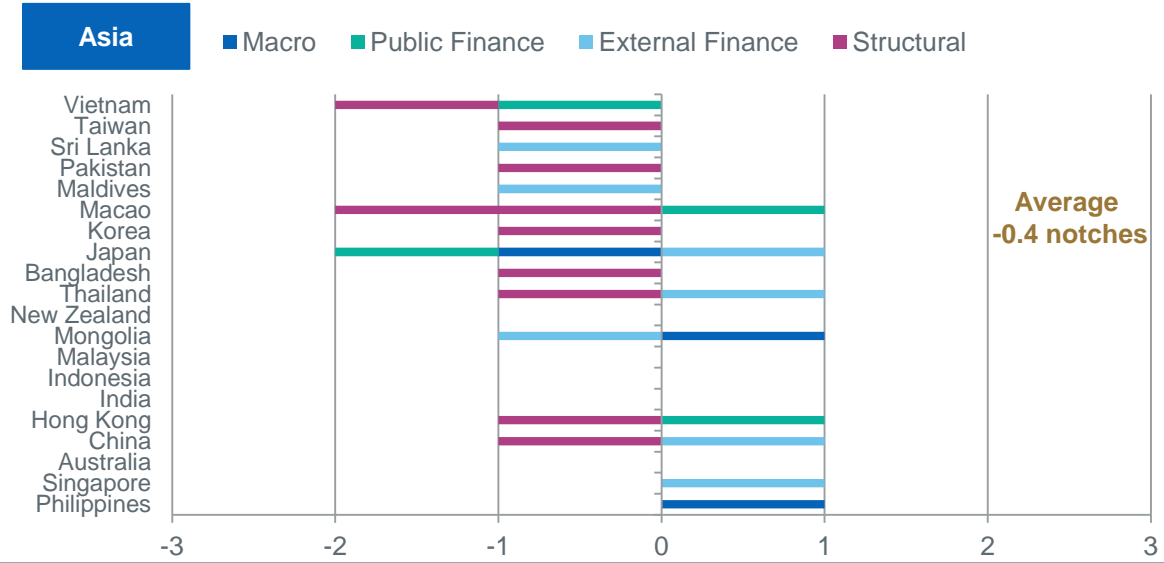
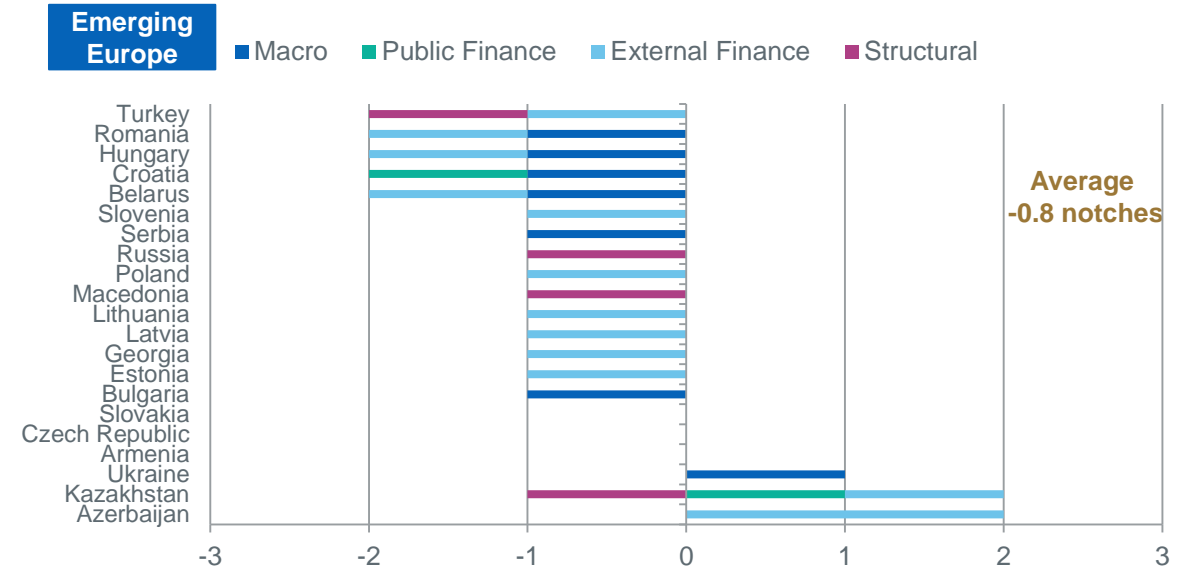
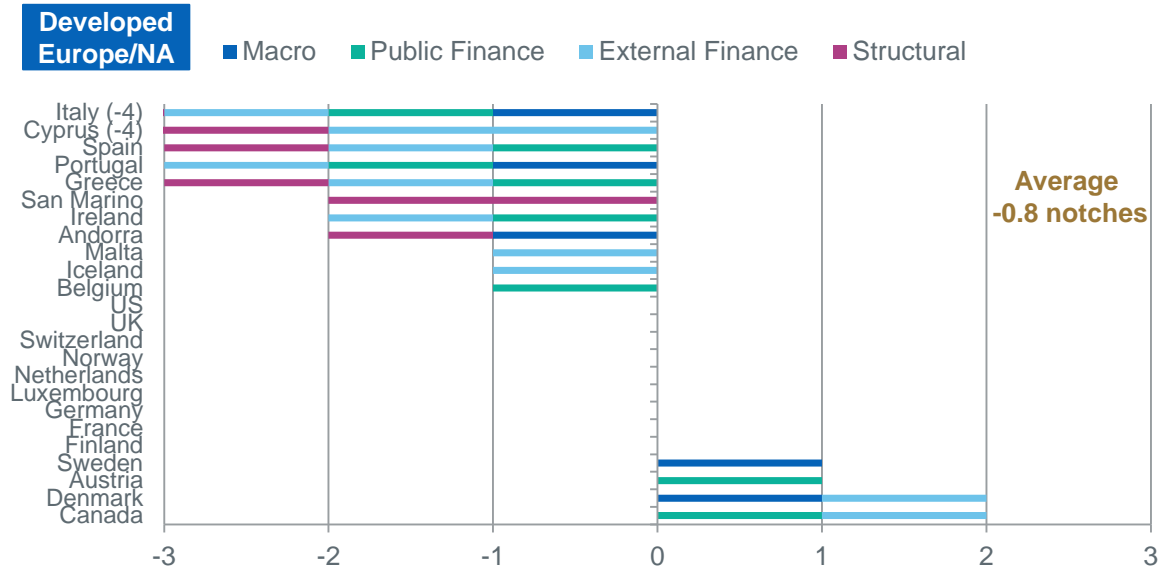


# Appendix 1 – Sovereign Rating Criteria Overview

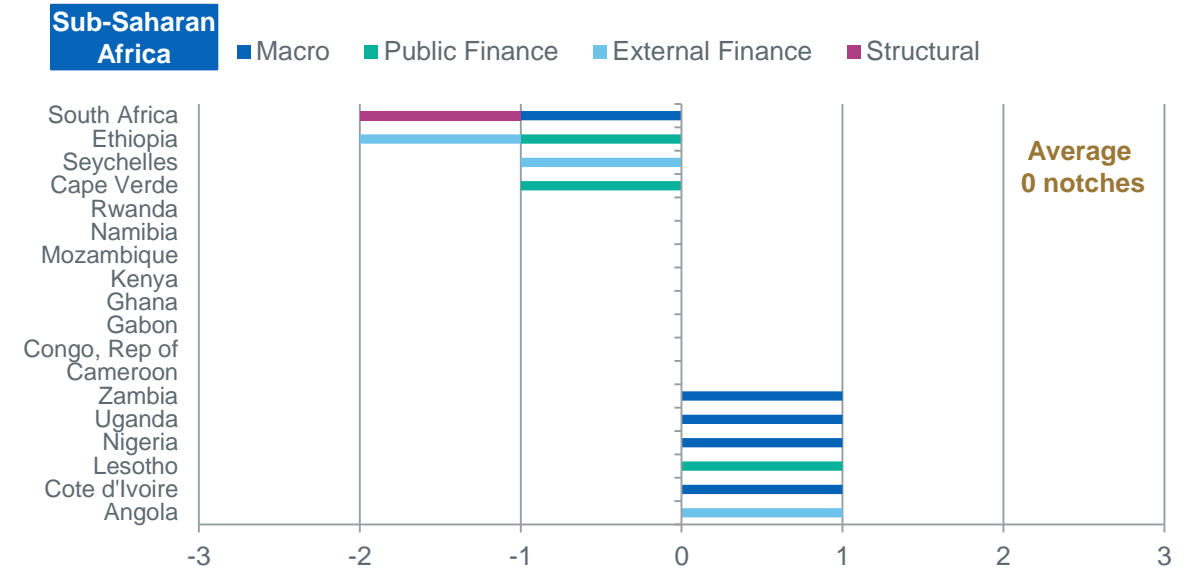
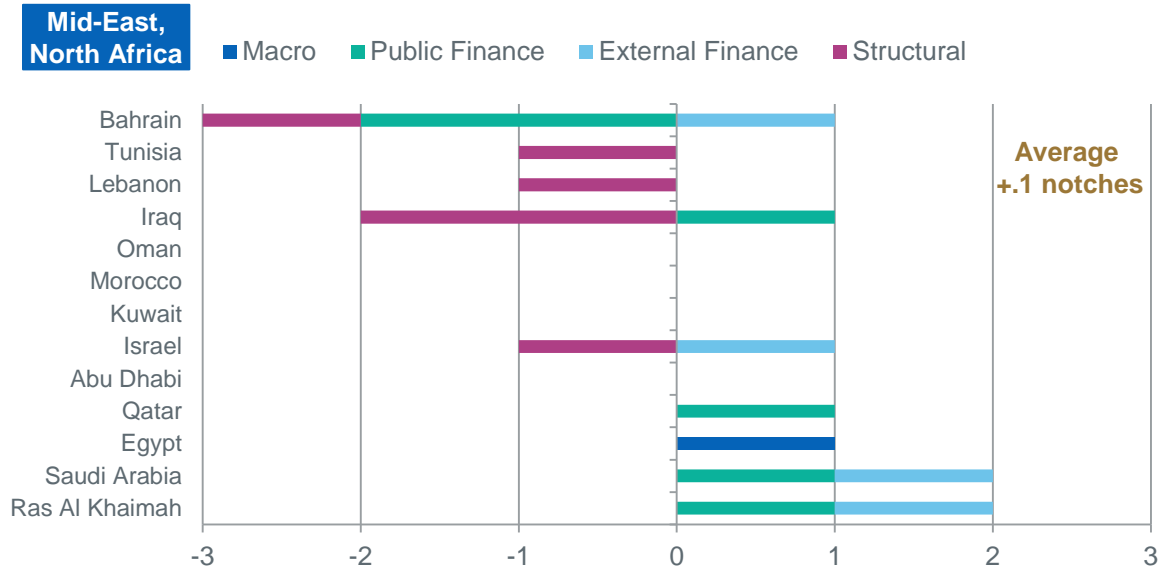


The Sovereign Rating Model estimates a predicted rating based on 3-year averages (t-1, t, t+1), then the Qualitative Overlay is applied (+3 to -3 notches) by the rating committee to account for issues and factors not captured by the data

# Appendix 2 – Qualitative Overlay by Region



# Appendix 2 – Qualitative Overlay by Region



## Outliers

- Outliers:
  - Cyprus, Italy and Costa Rica 4-notch negative adjustment
- CCC ratings and lower:
  - Congo (Republic of) rated CC
  - Mozambique and Venezuela rated RD

## The Importance of Political Risk

- As of end-June 2018:
  - Most of the sovereigns with a negative adjustment for Structural Issues have political risk noted as a weakness, about 20% of rated sovereigns

Source: Fitch, as of 2 July 2018

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